THE IMPACT OF THE DODD-FRANK ACT AND BASEL III ON THE FIXED INCOME MARKET AND SECURITIZATIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTEENTH CONGRESS

SECOND SESSION

FEBRUARY 24, 2016

Printed for the use of the Committee on Financial Services

Serial No. 114–74

U.S. GOVERNMENT PUBLISHING OFFICE

23–717 PDF WASHINGTON : 2017

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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THE IMPACT OF THE DODD-FRANK ACT AND BASEL III ON THE FIXED INCOME MARKET AND SECURITIZATIONS

Wednesday, February 24, 2016

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Royce, Neugebauer, Duffy, Stivers, Hultgren, Wagner, Messer, Schweikert, Poliquin, Hill; Maloney, Sherman, Hinojosa, Lynch, Scott, Himes, Ellison, and Carney.

Ex officio present: Representative Hensarling.

Also present: Representatives Barr and Capuano.

Chairman GARRETT. Good morning, everyone. The Subcommittee on Capital Markets and Government Sponsored Enterprises will come to order.

Today's hearing is entitled, "The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations."

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. And also, without objection, members of the full Financial Services Committee who are not members of the subcommittee may sit on the dais and participate in today's hearing.

I will now recognize myself for 3 minutes for an opening statement.

Today, we are here to examine the impact that Dodd-Frank, as I said, and an old rule stemming from Basel III are having on our fixed income and securitization market and, more broadly than that, to begin to examine the impact that they are having on our economy and job creation in the United States.

And I thank each and every one of our many witnesses for being here today. This is one of the largest panels we have had in a little while here at the subcommittee, so I feel bad for some of those who are maybe squeezed in the middle, in the very middle. And maybe those at the very end who can then sum up what everybody else said here. I hope you feel well at home.

I also want to thank the sponsors of the legislation that we will be considering today for their work on some of the very important issues that we will be discussing.

Some of us will recall that nearly 5 years ago when former Fed Chairman Ben Bernanke was here, he was asked whether the Fed or any regulator had simply considered the cumulative impact of this tsunami of post-crisis rules.

And you may remember his answer to that. It was one word: No. More recently, both Treasury Secretary Lew and Fed Chair Yellen have also admitted, when asked the same question from this committee, that despite the fact that regulators are rolling out evermore complex capital liquidity rules, nobody has taken a moment to study how they will all work combined or in tandem with one another.

So instead of a coordinated, well-thought-out legislative and regulatory approach in the wake of the financial crisis, what do we have? What we have instead is a series of ad hoc initiatives that are ostensibly designed to make the financial markets safer, but which in reality will only serve to put a lid on our economic potential in this country while sowing the seeds of the next financial crisis.

As the saying goes, do not confuse motion with progress.

This misguided approach began with the Dodd-Frank Act which was rushed through Congress on a partisan vote with little regard for what its provisions would mean for Main Street America. Take, for example, the treatment of collateralized loan obligations, or CLOs.

CLOs, as we all know, are vitally important to a $420 billion asset class that provides financing to Main Street businesses, which have performed extraordinarily well relative to all the other asset classes.

Yet, the risk retention rules that Dodd-Frank created treated CLOs as a highly risky asset, perhaps because the then-Majority thought that anything with an acronym sounded risky to them.

The same could be said for certain commercial mortgage-backed securities under the risk retention rules.

And so, I want to take a moment to thank Mr. Barr and Mr. Hill for putting together legislative solutions that would address Dodd-Frank's risk retention rules and also to help preserve these financing mechanisms—alphabet soup, if you will, of capital liquidity rules stemming from Basel III and the impact that they will have on fixed income and securitization markets, both of which are vital sources of financing in this country.

Prudential regulator overlords that make up the Basel Committee have made it their mission to stamp out risk in our capital markets by issuing a burdensome and extraordinarily complex set of rules. And these rules come with innocent-sounding names such as liquidity coverage ratio or net stabilized funding ratio or fundamental review of the trading book.

We know that in reality, these rules could have the ultimate effect of increasing risk in the banking system, cutting off services for non-financial end users, and putting American businesses at a disadvantage relative to their European counterparts.

And so, I look forward to our subcommittee stepping up today and examining these issues that the regulators have failed to do over the years.

Again, I thank all of our witnesses, and the sponsors of the bills as well.

And we will now yield 5 minutes to the ranking member of the subcommittee, Mrs. Maloney.

Mrs. MALONEY. Thank you. Thank you, Mr. Chairman, for calling this hearing.

And I thank all of our panelists for being here today.

The U.S. bond markets are incredibly important to our economy. They allow companies of all sizes to raise capital, to expand their businesses, to hire more employees or to invest in new equipment.

U.S. companies raised a record $1.5 trillion in the bond market in 2015. But it isn't just corporations that raise money in the bond markets. All types of loans, from mortgages to auto loans, are funded in the securitization markets.

So these markets are a key part of our economy and it is appropriate for us to review the state of these markets.

However, we also need to keep in mind that the securitization market, particularly for subprime mortgages, was a source of a lot of problems during the financial crisis.

Many of the banks that were making the mortgage loans or packing together mortgage-backed securities did not retain any of the risk for themselves, which meant that they didn't have a strong incentive to make sure that the loans were high-quality and that the borrowers could afford them.

Dodd-Frank addressed this problem by requiring that the sponsors of securitizations retain at least 5 percent of the risk on their own balance sheets. This rule, known as the "risk retention rule," was intended to align the interests of the sponsors with the interests of the investors in the securitization. If the underlying loans go bad, both the sponsor and the investor will suffer.

Former Chairman Barney Frank called the risk retention rule, "the single-biggest issue that we dealt with in Dodd-Frank."

Two of the bills that we are considering today would codify exemptions to the risk retention rule that go beyond what the regulators determined was appropriate. One bill would broaden the exemption for commercial real estate loans from the risk retention rule, while the other would create a new exemption for securitizations of certain corporate loans.

While I am interested in hearing from our witnesses on these bills, I think we should be very careful about rolling back such an important rule, which was one of the most important aspects of Dodd-Frank, especially before the rule has even taken effect.

The third bill that we are considering today is sponsored by my good friend from Massachusetts, Mr. Capuano. His bill would make a technical fix to the Volcker Rule that would avoid the need for banks to rename huge numbers of funds for no good reason.

The Volcker Rule prohibits banks from owning hedge funds or private equity funds. And I believe this is critically important because it prevents banks from taking on the risks that come with hedge funds and private equity funds which are not appropriate for banks.

However, the Volcker Rule does allow banks under limited circumstances to organize and offer hedge funds in private equity funds. In other words, the bank can help get the fund started, but once the fund is up and running, the bank cannot have a significant ownership stake in the fund.

One condition of this exception for getting a fund started is that the bank and the fund can't share the same name or a variation of the same name. The intent of this name-sharing ban was to ensure that banks don't feel obligated for reputational reasons to bail out a fund that is initially organized.

By a quirk of the way the Volcker Rule was drafted, however, this name-changing ban applies not just to the bank's name, but also to any investment adviser that is affiliated with the bank, even if the investment adviser has a completely different name than the bank.

It is not clear to me how this furthers the original goal of deterring banks from bailing out funds that they organized since the fund would have a completely different name than the bank.

So I look forward to the discussion of Mr. Capuano's bill, and the other two bills, and the testimony today.

Thank you very much. And I yield back. Thank you.

Chairman GARRETT. I thank the gentlelady.

I now yield 2 minutes to the vice chairman of the subcommittee, Mr. Hurt.

Mr. HURT. Thank you, Mr. Chairman.

This committee has heard time and time again about the unintended consequences and negative impacts on the economy of Dodd-Frank and the Basel III capital requirements.

When I travel across Virginia's 5th District, I continue to hear from my constituents that Washington is making it harder, not easier, for them to do business.

America's deep and liquid capital markets have a direct impact on Main Street businesses and consumers all across our country. And if Washington persists in imposing a one-size-fits-all approach, these capital markets and those who depend on them will be adversely affected. And this means less opportunity and fewer jobs for the people that we represent.

While it is important to maintain a strong and robust financial system, capital requirements must take into account the complexities of different business models. The domestic securitization market has a profound impact on consumer lending, from auto loans to credit cards.

If this market becomes unstable and uncompetitive, it follows that many domestic market participants will be encouraged to shutter their securitization businesses and allocate capital and resources abroad. If this happens, it will impact hardworking Virginians.

It is easy for unelected bureaucrats to make these decisions, but ultimately the people across Main Street America are those who feel the impact.

I am hopeful that our witnesses will be able to address some of these concerns.

I appreciate the committee's focus on this issue and its continued focus on ensuring that our small businesses and startups have the

ability to access the necessary capital in order to innovate, expand, and create the jobs that our local communities need.

I look forward to hearing from our witnesses.

And Mr. Chairman, I thank you for the time, and I yield back.

Chairman GARRETT. Thank you. The gentleman yields back, all time having been consumed.

We now turn to our panel. And again, thank you, all the members of the panel, for being with us today for this hearing.

We will begin with Mr. Carfang. But before we do that, just for those of you who have not been here before, without objection, your complete written statements will be made a part of the record, and you will be yielded 5 minutes at this time.

Mr. Carfang?

STATEMENT OF ANTHONY J. CARFANG, PARTNER, TREASURY STRATEGIES, INC.

Mr. CARFANG. Thank you, Chairman Garrett, and members of the subcommittee. My name is Tony Carfang and I am a partner with Treasury Strategies. We are a consulting firm that specializes in Treasury management, payments, and liquidity.

I am here today on behalf of our several hundred clients—businesses, State and local governments, financial institutions, hospitals, and universities—who are active participants in the capital markets and rely on fixed income and securitization for their short-term capital requirements.

Our American capital markets are the broadest and deepest and most robust in the world and we applaud all the work that has been done since the financial crisis to make them safe and to help keep them that way.

Unfortunately, many of the regulations, which in isolation further specific objectives, in combination we are now seeing as they are beginning to be implemented are causing some toxic interaction. In some sense and in some parts of the market, it is kind of like a high school chemistry experiment gone awry. When we put all these things in the same tube, all sorts of things are happening here. And some parts of the market are being clogged and choked.

We applaud your efforts in considering the three bills that are under consideration today. And what I would like to do is sort of set a context for what is happening in the capital markets as a result of this chemical interaction, which argues for the need for specific items of relief.

And I would like to say a word about risk retention. As all of our clients know, risk can neither be created nor destroyed. It can only be transformed; it can only be shifted. And to think that risk retention in and of itself will eliminate risk is kind of like thinking that car insurance will make you a better driver. It doesn't happen; it just shifts the responsibility to someone else.

Now, how do we know that this chemical reaction has gone awry? Let me state a couple of things that we see in our consulting practice and our clients are struggling with every day.

Since the regulations following the financial crisis have begun to take shape, there are 1,460 fewer banks in the United States than there were in 2010. That is a 20 percent decline. And that means that capital formation, particularly for small businesses and mu-

nicipalities, is bottle-necked, there is less choice, there is less opportunity.

In the 80 years that the FDIC has been chartering banks, in the United States we have created about 150 new banks each and every year going back through the 1930s.

In 2010, only 5 new banks were chartered. And in the 5 years since 2010, a grand total of only 2 additional banks have been chartered.

So we are not getting the innovation, we are not getting the robust formation at the bottom of the pyramid, which we all need.

I would like to turn our attention to money market funds in particular. Prime money market funds provide the short-term capital for businesses and for financial institutions. They buy their short-term paper.

Prime money market funds are the subject of an SEC regulation designed to take effect in October. And since the regulation was announced, 56 prime money market funds have converted to government money market funds, which means that about $264 billion that used to be lent to U.S. businesses and financial institutions is now tucked away in government securities. That money has been removed from the private economy.

Now, one particular item of concern is the tax-exempt money market fund which municipalities rely on for their infrastructure improvements, for their schools, their roads, their hospitals, college dormitories, and whatever.

Since the enactment of the regulation—in my testimony when I wrote this last week, I said that 27 tax-exempt money market funds had been closed. And as a result, some municipalities and State governments will not get the financing that they need.

Since then, in just 1 week, that 27 has grown to 45. And just this morning, there were announcements of closures of tax-exempt funds that specifically service Massachusetts, New York, and California municipalities.

So, we have a serious problem here.

Mr. Chairman, you mentioned Basel III and the alphabet soup, the HQLA and all these capital requirements. What that does is it impairs the banks' ability to lend and sends investors off the grid.

So in conclusion, I want to say that these regulations have stranded quite a bit of capital. And we need to put that back into the productive economy, and the three pieces of legislation you are considering today are a great step toward that end. Thank you very much.

[The prepared statement of Mr. Carfang can be found on page 52 of the appendix.]

Chairman GARRETT. Thank you.

Moving next to, from the Loan Syndications and Trading Association, Ms. Coffey. Welcome to the subcommittee. You are recognized for 5 minutes.

STATEMENT OF MEREDITH COFFEY, EXECUTIVE VICE PRESIDENT, LOAN SYNDICATIONS AND TRADING ASSOCIATION

Ms. COFFEY. Great, thank you. And good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

My name is Meredith Coffey. I am EVP of research at the LSTA and I am here to speak about QCLOs.

Now, it is important to note the LSTA does not represent the CLO market. Instead, we represent the $4 trillion corporate loan market.

Our concern here today is risk retention, how it could diminish CLOs and how that could impact and hurt the corporate loan market. This in turn would hurt U.S. companies' access to credit. It is the loans they need to expand, to refinance, to merge and grow, and to create jobs. That is why we are here today.

What we would like to discuss today is: one, how important CLOs are for lending to U.S. companies; two, how risk retention already has impacted the CLO market; and three, we want to voice our support for H.R. 4166 introduced by Representatives Barr and Scott.

This bill offers a solution that meets both the letter and the spirit of the Dodd-Frank Act, we will talk about why, and it will permit a safe and well-managed CLO to continue to provide financing to American companies.

To start off, I would like to discuss the non-investment-grade loan market. The reality is most American companies are not large investment-grade companies, like Microsoft, McDonald's, and Walmart. The vast majority of American companies are non-investment-grade. Moody's rates 2,000 companies, and 70 percent of those are non-investment-grade.

Who are these companies? They are cable companies, like Cable Vision. They are airlines, like Delta and American. They are food companies, like Dole and Del Monte. They are restaurant chains, like Wendy's, Burger King, and Dunkin Donuts. And if you need to burn those donuts off, they are also gym companies, like 24-Hour Fitness and Equinox.

The reality is CLOs provide more than $400 billion of financing to these companies and others like them. So why do folks get so concerned when they hear CLO?

In large part, it is because folks assume that these must be CDOs. They are not CDOs. CLOs are not CDOs; they do not perform like them. They are not originated to distribute securitizations. CLOs are just simple and transparent portfolios of corporate loans.

In a report released in June 2015, Moody's Investors Service calculated the 10-year impairment rate of CLOs. It was 1.5 percent. For CDOs, it was 45 percent, nearly 30 times the impairment rate from CLOs. CLOs are clearly not CDOs.

Unfortunately, risk retention will do great damage to CLOs and to the companies that rely upon them. Last week, Moody's issued a report on companies' needs to refinance and noted that CLOs will meet a smaller portion of corporate refunding needs due in part to risk retention.

In fact, risk retention already is affecting CLOs. Starting in the second half of 2015, last year, investors began requiring CLOs to be risk-retention compliant or at least have a detailed plan to comply. Why? Because the investors required CLOs to show they had the ability to refinance or at least show the fact that they would exist in 2 years.

The result? CLO formation dropped 20 percent last year. Second-half 2015 CLO formation was down 40 percent from first-half levels.

And risk retention is already picking winners and losers. Thirty CLO managers that issued CLOs in 2014 could not do so in 2015, largely due to risk retention. This is not just a CLO problem. It will impact a number of companies' ability to refinance their debt.

Moody's said non-investment-grade companies have more than $700 billion of debt coming due in upcoming years. Bloomberg reported that Fed officials have begun to worry about credit availability. And regulators themselves have said risk retention will reduce the supply of credit.

So what will happen? If U.S. companies cannot refinance their debt because CLOs are not there for them, companies either will have to pay out substantially to entities like hedge funds, or worse, they may not find credit and this could lead to downsizing, job cuts and, worst-case scenario, hospital bankruptcies.

But this scenario does not need to happen. Instead of curtailing the CLO market, we ask the committee to consider and pass H.R. 4166 which contains a sensible alternative, the QCLO.

How does this work? A CLO would have to meet requirements in six areas: asset quality; portfolio diversification; capital structure; alignment of interest; regulation of the manager; and enhanced transparency and disclosure.

If a CLO does this, then the manager can purchase and retain 5 percent of the equity, which critically, along with the subordination of its fees, would absolutely meet the 5 percent risk retention requirement in Dodd-Frank.

Thus, the QCLO not only requires 5 percent credit risk retention, but it also adds quality restrictions into the mix.

Thank you very much for your time. I look forward to any questions you may have.

[The prepared statement of Ms. Coffey can be found on page 61 of the appendix.]

Chairman GARRETT. Thank you very much for that.

Mr. Green, welcome to the panel, and you are recognized for 5 minutes.

STATEMENT OF ANDREW GREEN, MANAGING DIRECTOR, ECONOMIC POLICY, CENTER FOR AMERICAN PROGRESS

Mr. GREEN. Thank you, Chairman Garrett and Ranking Maloney, for the opportunity to testify on this important topic.

I am Andy Green, managing director of economic policy for the Center for American Progress.

And I would like to make five points today: first, that fixed income markets are better thanks to Dodd-Frank and Basel III; second, reforms reduced what Paul Volcker calls the liquidity illusion, helping to protect us from bubbles and bailouts; third, transparency in the fixed income markets should be increased; fourth, Congress and regulators should be proud of the changes put in place and finish the job; and lastly, the bills being considered today by the subcommittee are unwise and unnecessary, and they should not be adopted.

First, fixed income markets are better. For months, the financial industry has warned of a so-called liquidity crisis following the implementation of new and supposedly burdensome regulations.

The argument goes as follows. Basel III capital charges, the Volcker Rule, limits on risk taking and holding positions are killing dealer inventories. Without inventories, clients would not be able to trade. Spreads will widen and costs of financing will go up, and the real economy will be harmed.

But as Paul Volcker and others have long known, reality is entirely the opposite. Don't take my word for it or even his. The New York Fed, of all places, and FINRA, the broker-dealer self-regulatory organization, have all concluded that liquidity is as good or better than pre-crisis levels.

Here is the data. Primary issuance of corporate bonds is above pre-crisis levels. A record $1.5 trillion was issued in 2015 compared to approximately $750 billion in 2005.

Borrowing costs are at or near all-time lows. Overall, even asset-backed securitization issues also look similar to the levels that existed in 2000, 2004. All of this varies by particular market.

Indeed, a major concern among economists has been overheating of credit markets.

Second, in most key respects, the trading market continues to perform very well. Bid/ask spreads and corporate bond markets are 10 to 25 percent tighter compared to the lows prior to the crisis. The price impact for trading blocks, another good measure of trading costs of liquidity, are actually as good or better than 2005, some of the lowest points of the pre-crisis period.

Certainly, trade sizes are down somewhat, as is turnover. This not clearly good or bad. Other market structure factors, such as rising automation and increased DTF trading or greater concentration on the buy and the sell sides may be at play. Notably, we do not see price impacts.

In short, to sum up in the words of New York Fed President Bill Dudley, "There is limited evidence pointing to a reduction in the average levels of liquidity."

Some have expressed concern regarding what might happen when markets are the next air patch. A hypothesis goes that a liquidity crisis will result, but this is largely mistaken. Dealers do not catch the falling knife. Instead, they respond to similar incentives motivating other investors to sell.

Secondly, it is important not to confuse trading volumes with liquidity. Liquidity is not a price guarantee. High volumes in fact can lull market participants into believing they can get out at any time, at any quantity, in any market circumstance, without observing any price change. This is what Paul Volcker calls the "liquidity illusion."

Not only is this dangerous, this is dangerous because it diminishes investor responsibility and harms the ability for the capital markets to efficiently allocate resources to the real economy.

The changes put in place since the Dodd-Frank have made us safer. So what should we do? We should do several things.

We should be increasing transparency. Just as the introduction of the TRACE reporting system in 2002 brought trading costs down significantly, enhanced reporting in the Treasury markets, in tri-

party and bilateral repo markets relating to investor costs, as folks like Commissioner Piwowar and Commissioner Stein of the SEC have all urged. These can make significant improvements.

In particular, we also need to move faster to modernize financial industry disclosures.

Also, it is important that we finish the job. The stronger performance of the U.S. banking sector compared to the European banking sector demonstrates the importance and value of U.S. reforms.

The movie, "The Big Short" reminds us of the importance of the provisions of Dodd-Frank that ban the very conflict-ridden practices that corrupted our securities markets. The SEC needs to finish them immediately and it needs to finish the job on implementing CDS infrastructure swap market reforms.

I would also urge the committee not to adopt the bills under consideration today. They are over-broad, unwise, and unnecessary.

In short, what we simply need to do is move forward with compliance, as Paul Volcker has said, for the good of the country.

Thank you very much for the opportunity to speak before this committee.

[The prepared statement of Mr. Green can be found on page 73 of the appendix.]

Chairman GARRETT. And next we have Mr. Johns—welcome to the panel as well. And you, too, are recognized now for 5 minutes.

STATEMENT OF RICHARD A. JOHNS, EXECUTIVE DIRECTOR, STRUCTURED FINANCE INDUSTRY GROUP

Mr. JOHNS. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, my name is Richard Johns and I am the executive director of the Structured Finance Industry Group (SFIG).

Prior to SFIG, I spent over 22 years in the finance industry, including as head of global capital markets at Capital One, where I was responsible for all fixed income funding before and during the financial crisis. I was global head of funding and liquidity at Ally Financial after the crisis.

Today, I am testifying on behalf of the 350 institutional members representing all areas of the securitization industry, including investors and issuers.

I will testify to a number of global regulatory issues that affect lending across asset classes, including the definition of high-quality liquid assets under the joint agency's liquidity coverage ratio (LCR), international efforts to create a high-quality securitization definition, BASEL capital rules, and the fundamental review of a trading book.

First, beginning with the LCR, we believe the new LCR rules are misguided in several areas. First, the LCR does not treat any class of asset-backed securities as high-quality liquid assets, essentially branding all ABS as illiquid. This blanket exclusion is unwarranted. High-quality ABS are among the most liquid assets that a bank can hold.

Before, during, and after the credit crisis, credit card and auto ABS largely retained market access and performed better than investment-grade corporate debt which was granted HQLA status.

Second, the implementation of various Dodd-Frank requirements have created significant changes in practice across the entire securitization industry. If these changes are deemed to have any value at all, then how can an ABS security, previously deemed to have zero liquidity, still be deemed to have zero liquidity after the implementation of Dodd-Frank?

Effectively, we are being told by our regulators that zero plus something equals zero.

In Europe, a less-liquid market than the United States, policymakers are actively recalibrating this potential over-regulation and have identified high-quality criteria for asset classes that they believe warrant preferential capital treatment.

This concept has been extended to global securitization through a similar initiative undertaken by Basel and IOSCO. However, while the rest of the world moves forward, U.S. regulators have shown no interest in following a similar course.

If this continues unchecked, then European investors will receive capital relief on local collateral and will be incentivized to invest locally, leaving a risk of market fragmentation, thereby reducing market liquidity.

If other countries implement IOSCO/Basel criteria, then all global investors except U.S. investors will receive preferential capital treatment, creating a risk of over-reliance on non-U.S. funding in our capital markets and, consequently, our economy.

Compound that with recent developments of Basel's fundamental review of a trading book which sets capital standards for broker-dealer inventory. A major driver behind U.S. marketplace rebounding more quickly from a credit crisis was the crucial role of the market maker, a role that simply isn't replicated by any other country's capital market. They did catch the falling knife.

Without bid/offer levels and inventory capabilities, investors would not feel confident the securities they buy will also be able to be sold.

Early indications suggest that capital may increase by up to 50 percent, causing market marking to become uneconomical and broker-dealers to potentially exit the market. Investors are already concerned that this may cause illiquidity.

These unjustified increases in capital follow perhaps the largest example of redundant capital created when the FAS 166/167 accounting standards forced issuers to hold reserves against losses, despite the contractual transfer of risk of loss to investors.

Despite the fact that we know investors took losses during the credit crisis, issuers are still required to hold reserves against every dollar of risk transferred. Layer in the fact that banks must also hold 10 percent regulatory capital against that same risk creates a duplication and redundancy of capital that, if corrected, could generate tens of billions of dollars in lending to consumers and businesses in your districts.

Therefore, we recommend the following actions: require U.S. regulators to examine the combined effects of regulations on ABS liquidity; require U.S. regulators to work with international regulators to develop a globally consistent standard for high-quality securitization; designate high-quality ABS and MBS as HQLA under the final LCR rules; re-examine loan-loss reserve accounting

to ensure that reserves are only being held against actual contractual obligations; and finally, support H.R. 4166, which our members, issuers, and investors alike, believe creates a workable option for CLO risk retention.

Thank you for the opportunity to testify. And I look forward to your questions.

[The prepared statement of Mr. Johns can be found on page 85 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

Dr. Stanley, welcome to the subcommittee, and you are now recognized for 5 minutes.

STATEMENT OF MARCUS STANLEY, POLICY DIRECTOR, AMERICANS FOR FINANCIAL REFORM

Mr. STANLEY. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

My name is Marcus Stanley and I am the policy director of Americans for Financial Reform.

The issues examined by the committee today, including securitization market activities in bank trading books and liquidity, go to the very heart of the 2008 financial crisis.

Indeed, a shorthand description of that crisis might read irresponsible practices in securitization markets infected the trading books of key dealer banks, leading to a catastrophic failure of market liquidity.

It is therefore not surprising that the Dodd-Frank Act targeted these areas for reform. Now some are calling these reforms into question because of their supposed impacts on market liquidity.

We oppose these efforts to roll back post-crisis reforms. It is particularly ironic that they are being advanced in the name of increasing liquidity.

A central lesson of the 2008 crisis is that market liquidity can be excessive, the liquidity illusion that Mr. Green referred to, and that such excessive liquidity leads to disastrous market crashes that have far more damaging liquidity effects than any that might be created by prudent limits on excessive leverage and risk-taking in normal times.

Indeed, the financial crisis led most securitization markets to essentially shut down to new issuance for a period of years, an impact that dwarfs any marginal effect on such markets that could emerge from Dodd-Frank reforms designed to improve securitization quality.

There has been a great deal of speculation about changes in liquidity due to regulation, but very little hard evidence. Quantitative analyses have not found changes in liquidity that appear economically meaningful.

Indeed, where such changes are seen, they often appear positive, such as compression and spreads. There does appear to have been some decline in average trade size, but changes in trade size do not appear to have had an impact on investor costs. And any impact on systemic risk is, at this point, extremely hypothetical.

There has also been some increase in the frequency of brief but disruptive flash crashes. These are probably due to the growth in high-frequency, algorithmic electronic trading, rather than to new

financial regulations. Regulators should address the risks of such electronic trading as a separate matter.

Any changes in fixed income market liquidity also do not appear to have blocked the—bond issuance over the past few years has soared to levels well in excess of pre-crisis highs. And returns to municipal bonds, in other words the costs of borrowing from municipalities, are at 50-year lows.

Two bills before the committee today would fatally weaken Dodd-Frank risk retention rules designed to improve asset quality and securitization markets. These bills go far beyond the sensible underwriting-based exemptions that regulators have already placed in their final risk retention requirements.

H.R. 4166 and the CMBS discussion draft would enormously increase the scope of exemptions and prevent regulators from applying reasonable underwriting standards.

For example, H.R. 4166 apparently completely eliminates any controls on leverage of the borrowing company receiving a commercial loan as a requirement for CLO risk retention.

The CMBS discussion draft exempts interest-only loans from risk retention requirements and provides a blanket exemption for all single-loan securitizations regardless of underwriting quality.

We urge the committee to reject this legislation and to preserve the positive incentives created by risk retention which would be fatally undermined by the over-broad exemptions in these bills.

As laid out in my written testimony, AFR also has some concerns with H.R. 4096 on Volcker Rule naming restrictions. As the bill is currently drafted, it seems to leave open some possibilities for naming practices that could create an inappropriate inference of sponsorship.

We would oppose the bill as currently drafted, but are open to work with the sponsors on potential changes to the bill.

My written testimony also discusses the importance of other reforms, such as the fundamental review of the trading book. The fundamental review of the trading book is directly aimed at issues revealed by the financial crisis that permitted banks to borrow excessively against assets in their trading books.

I would like to close with a piece of good news. Yesterday, the FDIC announced that over 95 percent of American community banks were profitable over the year 2015. This is up from just 78 percent in 2010, the year that the Dodd-Frank Act was passed. This is just one example of what I believe are many positive elements of our financial markets that have occurred under Dodd-Frank.

Thank you, and I look forward to answering your questions.

[The prepared statement of Dr. Stanley can be found on page 158 of the appendix.]

Chairman GARRETT. Great.

Mr. Plunkett, welcome to the panel, and you are recognized now for 5 minutes.

STATEMENT OF JEFFREY PLUNKETT, EXECUTIVE VICE PRESIDENT AND GLOBAL GENERAL COUNSEL, NATIXIS GLOBAL ASSET MANAGEMENT

Mr. PLUNKETT. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

My name is Jeff Plunkett, I am general counsel of Natixis Global Asset Management. We are a wholly owned subsidiary of Natixis, a French bank that operates a single branch office in New York and does not accept FDIC-insured deposits.

Natixis and each of its affiliates, including each investment manager affiliated with us, is, however, considered a banking entity under the Volcker Rule.

Asset managers play an important role in the global financial system. Through our clients' funds, we provide an important source of capital formation and liquidity to markets worldwide. We serve individual investors' retirement planning by managing pension, 401(k), mutual fund, and personal investments.

Innovative asset managers provide new products that help individuals save for retirement. Asset managers affiliated with banks also contribute a source of revenue that is not dependent on the capital of the parent bank.

Each of our managers operates under its own historical name and branding. And with only a couple of exceptions, none has Natixis as part of its name or logo. Each of our U.S. managers is also separately registered with and regulated by the SEC.

I am pleased to be here today and to have this opportunity to discuss H.R. 4096, the Investor Clarity and Bank Parity Act. H.R. 4096 would make a very limited modification to the Volcker Rule.

The Volcker Rule, as noted by Ranking Member Maloney, restricts the ability of banks and investment managers affiliated with banks to sponsor hedge funds and private equity funds. Investors in these funds are principally sophisticated institutions, such as pension funds, that are trying to diversity their investments and manage risk.

The Volcker Rule permits a banking entity to offer private funds, subject to certain conditions, one of which is that the fund may not share the same name or a variation of the name with the banking entity that is managing the investments.

Unfortunately, this provision is at odds with both industry practice and the goal of providing clarity to investors about who is managing a fund.

In our experience, most private funds contain the name or a variation of the name of the investment manager. Thus, a fund managed by ABC investment manager might be called the ABC private fund. This clearly distinguishes this private fund from other funds managed by other investment managers.

This practice has been in place for many years. And in our experience, investors in private funds prefer to see the name of the fund manager in the name of the fund.

Under the Volcker Rule, our managers and other bank-affiliated asset managers are now prohibited from using their name to identify their own private funds. This puts them at odds when investors desire full clarity and at a competitive disadvantage with independent asset managers.

The situation is even more illogical when the bank-affiliated managers have a name that is totally different from their parent bank, as we and certain others do.

The primary purpose of the name-sharing prohibition is to prevent investor confusion about who ultimately bears the risk of loss. However, this risk is already addressed in a number of ways in the Volcker Rule which requires that the banking entity not guarantee the performance of the fund, disclose clearly to investors that losses are borne solely by the investors and not by the banking entity, and clearly disclose that ownership interests in the fund are not insured by the FDIC.

These restrictions are more than sufficient to ensure that funds sponsored by a banking entity are understood by investors to be separate from their sponsor and their affiliated bank.

It is simply a quirk in the Volcker Rule that this applies to separately branded investment managers.

We support H.R. 4096 because congressional action is the only option to change the name-sharing prohibition. The prohibition was one of the most heavily commented-upon aspects of the Volcker Rule during its drafting, that the regulators concluded that the legislation was clear and adopted the restriction as proposed.

The regulators appreciated our belief that the Volcker Rule was not intended to affect the naming of funds where the investment managers' name did not link the manager to its parent bank. They said that the text of the Volcker Rule did not leave room for regulatory interpretation.

H.R. 4096 is a narrowly tailored piece of legislation that will provide necessary relief without undermining the intent of the Volcker Rule.

Mr. Chairman, we urge Congress to adopt H.R. 4096. Thank you very much. I would be happy to answer questions.

[The prepared statement of Mr. Plunkett can be found on page 111 of the appendix.]

Chairman GARRETT. Thank you, sir.

Last, but not least, Mr. Renna, thank you for being on the panel, and you are recognized for 5 minutes.

STATEMENT OF STEPHEN RENNA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, COMMERCIAL REAL ESTATE FINANCE COUNCIL

Mr. RENNA. Thank you, Chairman Garrett, and Ranking Member Maloney.

The Commercial Real Estate Finance Council, known as CREFC, is the trade association for the $3.5 trillion commercial real estate finance industry. Its 300 member companies include lenders of all types, balance sheet and securitized, as well as investors and servicing firms.

I am CREFC's president and CEO.

My testimony today will focus on the commercial mortgage-backed securities, or CMBS, side of the commercial real estate finance industry. This is the sector most affected by regulations.

I do want to note that CMBS is completely distinct from residential mortgage-backed securities (RMBS). Mrs. Maloney referred to

RMBS and the subprime loans that are well-known to have been within that and the problems they created.

Under RMBS, mortgages are underwritten at the borrower level. For CMBS, mortgages are underwritten at the asset level.

CMBS is about 25 percent of all commercial real estate lending, about $100 billion per year. It expands the pool of available loan capital beyond what balance sheet lenders, banks and insurance companies can contribute to meet borrower demand.

There is $600 billion of outstanding CMBS debt, $200 billion of which will need to be refinanced in the next 2 years. Many of the borrowers are in secondary and tertiary markets. CMBS financing may be the only or at least the most cost-effective financing they can get.

By providing access to the public capital markets, CMBS allows banks and other mortgage originators to free up their balance sheets so they can recycle their limited capital into new loans. It is efficient and de-concentrates risk that could otherwise overweight the balance sheets of banks as we saw during the great recession.

Several regulatory agencies have been tasked with working collaboratively on Dodd-Frank rulemaking. With such a daunting task, it is no surprise that many aspects of the rules apply broadly across asset types and lack specific correlation to the varying characteristics of different types of assets in sectors, such as CMBS.

The problem is that one-size-does-not-fit-all. To date, CMBS is subject to Reg AB, Basel III and, of course, Dodd-Frank risk retention and others. The sheer number of rules and their breadth is contributing to retrenchment by banks and illiquidity in the markets. In many cases, the regulatory burden outweighs the potential benefit the regulators are trying to achieve. Regulation is institutionalizing inefficiencies.

Today, CMBS investors are demanding return premiums similar to corporate junk bonds, yet property fundamentals are strong. Property owners face the prospect of higher rates on loans, tougher credit, and diminished property values as debt issuance slows. Estimates for this year's CMBS issuance have been downgraded from over $100 billion to $70 billion.

The market is becoming fragile, even before half of the plan regulations come into effect. Illiquidity and volatility are becoming the norm.

Why is the CMBS market suffering dysfunction? There are many macro, external factors disrupting the capital markets. But it is also clear that regulation has a role, too, and a big one.

Regulators have concluded that securitized loans are more risky than loans kept on balance sheet regardless of underwriting, credit or capital. The regulatory cost to capital they impose is simply based on the lending platform. This is a flawed premise.

Because of this burden, CMBS is losing institutional capacity, bank and mortgage originators are leaving or substantially reducing their commitment to the market.

Once industry capacity shuts down, it takes a long time before it returns. We saw that after the crisis in 2007. Loss of capacity is problematic in the short run and dire in the long run.

When we get to the point in the cycle where capital and credit gets scarce, and we will, then the loss of CMBS capacity will hit borrowers broadly and hard.

Additionally, CMBS bond investors typically are pension funds and insurance companies. What hurts CMBS hurts pensioneers and life insurance beneficiaries.

We urge Congress to provide modest relief from the risk retention rules for one sector of CMBS known as the single-asset, single-borrower market. This is embodied in Congressman Hill's discussion draft, which we urge the committee to support.

Single-asset, single-borrower is a securitization of a single, large mortgage on one asset, such as a mall, hotel or office building. Financing of these large, high-cost assets is often beyond the scope of one lender. Therefore, it is more efficient to use CMBS and, therefore, access the public capital markets.

Investors invest enthusiastically in single-asset, single-borrower securitizations because the assets perform extremely well and are easy to analyze and underwrite. This is not a multi-mortgage conduit transaction. The idea of risk retention was to protect investors buying securitizations where you had dozens of assets in a pool and it was hard for investors to analyze what they were buying.

Nevertheless, regulators with a broad brush applied risk retention to single-asset, single-borrower. This lacks rationale and will do more harm than good.

Not only does this add cost to borrowers and reduce yield to investors, it hampers the effectiveness of single-asset, single-borrower. We urge the committee to support Mr. Hill's discussion draft.

[The prepared statement of Mr. Renna can be found on page 116 of the appendix.]

Chairman GARRETT. I thank the gentleman.

At this point, we will turn to questions, and I will recognize myself for 5 minutes.

So, it has been a great discussion, with a great panel, and I appreciate very much getting into the weeds on a fairly complicated topic here. Let me bring it down to some simple point of view as I look at it.

First, was there a problem to begin with? And second, has the solution of Dodd-Frank caused any additional problems going along?

So a similar question was there seems to be some different views about this, about the performance of certain asset classes during the last decade, and particularly the years leading up to and around the financial crisis.

I will throw it out to Mr. Johns first and say, in a nutshell, how did highly rated asset-backed securities perform during the financial crisis relative to everything else out there?

And then, I will go to Ms. Coffey.

Mr. JOHNS. During the financial crisis, I was at Capital One, and we had, I would say, an auto and a card platform.

What I would say is that during the crisis, the loss performance performed very much in line with expectations if you are looking at prime auto, prime credit card, losses tracked, unemployment up

to a certain point in card space. Losses in auto stayed relatively low. I would say prime auto, generally less than 2 percent.

Chairman GARRETT. Ms. Coffey, you touched upon this before, but I just want to drive home the point.

Ms. COFFEY. Absolutely. CLOs performed extraordinarily well. In their 20-year history, the cumulative impairment rate for CLOs was 1.5 percent. That 20-year history includes the financial crisis, CDOs 45 percent, very different performance.

Chairman GARRETT. Okay. This jibes with what Mr. Johns is saying here as well. So we didn't really see a—although there was a point by Dr. Stanley talking about excessive liquidity, and I know you made reference to excessive liquidity leading to the potentiality for excessive leverage.

But when I was listening to that—there is a saying, and I had to remember what it is, "Causation is not always correlation."

The gentleman from Maine is not here, but I heard about a study once in the State of Maine where it said there was an uptick in the divorce rate in the State, and at the same time, there was an uptick in the use of margarine.

Now, you couldn't say in the case that there was a causation by people using more margarine that was a causation of the increase of divorce rates. I would just say that there was not a causation, but maybe just a correlation.

So can anyone else address the issue? Is there a correlation? Is there a problem, Mr. Renna, with a lot of liquidity in the marketplace?

Mr. RENNA. First, Chairman Garrett, to your question about, was there a problem before, the CMBS industry needed to address some issues within it and it did.

But I will say that bonds that were issued before the crisis, on AAA bonds, there are no losses on those AAA bonds. And single-asset, single-borrower securitizations had absolutely no losses.

Chairman GARRETT. So I guess the answer to the question is, even though you had a lot of illiquidity during that period leading up to that time, you did not see a problem.

So let us go to the second case. Now, we didn't see a problem, but we had Dodd-Frank to have all these regulations in there. The next question is, hey, is Dodd-Frank causing a problem? We have heard a couple of people say no, there is no problem in this marketplace. But that doesn't comport with what we have heard from a couple of other people.

The Chair of the Fed came here in March and acknowledged in testimony before this committee that, "There is no question that there are concerns about the liquidity in the fixed income market."

After her, we heard from Richard Ketchum from FINRA who said that, "There have been dramatic changes with respect to the fixed income market in recent years, many of them coming in reaction to the failures and the market impact coming out of the crisis. This led to much higher capital requirements, Volcker Rule," and he just goes on to agree basically, more emphatically, with Chair White.

Mr. Carfang, I only have a few minutes. You say in your testimony that, "The combination of the Volcker Rule and increased capital requirements results in financial institutions scaling back

their market-making activities. This rule sets in wider bid/ask spreads and, ultimately, too, less liquidity in the market."

Is that true, what you said there?

Mr. CARFANG. Absolutely, sir. In terms of putting this in context, the macro statistics belie what is actually happening in the economy. Yes, there are $1.5 trillion of new loans, but they are going only to the largest and most creditworthy borrowers and not the mainstream businesses or municipalities.

Chairman GARRETT. And is it true, also as you said, that there have been sporadic liquidity black holes in which when the markets completely freeze up or prices gyrate wildly since that time?

Mr. CARFANG. Absolutely. We had the U.S. Treasury flash crash about a year ago. And several other pockets where securities could not be sold at any price, albeit for short periods of time, but liquidity means it is there when you need it.

Chairman GARRETT. Sounds like a problem to me. Thank you.

I thank the panel.

At this time, I yield to the ranking member from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you very much.

Mr. Green, some of the witnesses here today have argued that the risk retention rule will raise the cost of credit and, therefore, should be rolled back. Didn't the regulators estimate that the risk retention rule would raise the cost of credit modestly, but decide that these costs were worth the benefits that the rule will provide?

For example, the Fed estimated that the rule would raise the cost of a certain commercial mortgage-backed securities by, most, one-quarter of 1 percent, but they determined that the benefits—better quality loans and fewer defaults—would far outweigh the costs.

Do you think the regulators were sensitive to the potential impact that the risk retention rule would have on the cost of credit when they were writing the rule? And in your opinion, will the benefits of the rule outweigh the costs?

I would like your comments, and also Dr. Stanley's.

Mr. GREEN. Thank you very much, Ranking Member Maloney. Absolutely, there are hundreds of pages of economic analysis that went along with the rule, carefully analyzed, carefully studied. And absolutely, the benefits far outweigh the costs.

These are common-sense solutions. We saw the terrible originate-to-distribute model that was—it was because there was not real risk retention that was transparently priced up front at the beginning of the transaction.

Risk retention really is just a transparency tool to make sure that the real risks of the loans are being repriced.

And to the point about the concerns that the chairman noted earlier from Chairs White and Ketchum, really what we have been seeing out there is that the data has shown the complete opposite. And we are far more secure. The costs of illiquidity from the financial crisis far outweighed any of the changes that are being brought about today.

Mrs. MALONEY. Okay, thank you.

Dr. Stanley, would you agree?

Mr. STANLEY. Absolutely. I think that this goes to the issue of excessive liquidity and its connection with financial risk.

The financial system is healthiest when risks are properly priced, which can sometimes mean that something is priced higher because people have the correct expectations about the potential market risks and credit risks that they are taking.

One thing that we learned in the financial crisis is it is very clear that when people are set up to think that they are making investments that have very low risks, and they suddenly decide that these risks are much higher than they thought, market chaos ensues, and we can see absolutely shutdowns of markets.

And Mr. Johns mentioned that some of these securitizations in the long run performed well in terms of people paying back their loans and so on. Well, that wasn't understood at the time.

And in fact, their market prices dropped very significantly during the crisis, not just in mortgage-backed securities, but in many other areas of securitizations as well. And that is why we saw shutdowns in these securitization markets for such a long period.

Mr. JOHNS. But what you are referencing there is an issue of transparency.

Mrs. MALONEY. Thank you.

My question now is to Mr. Plunkett. I have very limited time.

You noted in your testimony that investors in hedge funds and private equity funds are typically sophisticated, professional investors. And I personally think that is very important.

Do you think that sophisticated investors in a fund would already know who initially—

Mr. PLUNKETT. Thank you. Yes, the institutional investors will know as part of their diligence process. H.R. 4096 is just trying to promote transparency and make it easier for everybody to understand which manager is managing which fund.

Mrs. MALONEY. And would you say, in your experience, does having a fund you organized share a name with your investment adviser really hold your feet to the fire?

Mr. PLUNKETT. Our managers, and throughout the asset management industry, our managers try very hard to protect the interests of their clients, no matter what happens. The Volcker Rule prohibits, in any event, bailing out or guaranteeing funds. So the name-sharing really doesn't change that.

Mrs. MALONEY. So there are prohibitions, you would say, in Dodd-Frank now that would pertain to your inability to bail out a fund. In other words, could you bail out a fund under Dodd-Frank? Even if you wanted to, you are prohibited from doing so, aren't you?

Mr. PLUNKETT. Yes, we are.

Mrs. MALONEY. Okay.

And Mr. Green, some Republicans on this committee have argued that stronger regulation of the banking industry, and particularly the Volcker Rule, are harming the liquidity and our fixed income markets. Do you agree with that statement? What is your response to that?

Mr. GREEN. Yes, it is just absolutely the data has proven—the New York Fed has extensively studied, the New York Fed, very

close to Wall Street in terms of information, has absolutely concluded the data is not there.

We see record-high corporate issuances, record-low costs of capital. And bid/ask spreads and price impact for even large block trades is tighter than ever.

Mrs. MALONEY. Thank you very much. My time has expired.

Chairman GARRETT. I thank the gentlelady.

The gentleman from Virginia is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

I wanted to follow up on the chairman's line of questioning, specifically as it relates to the corporate bond market and the impact that post-crisis regulations, Dodd-Frank, et cetera, have had and what many are very concerned about. And Mr. Green has talked about that specifically.

I think it is interesting also that we have certainly had witnesses who have testified before this committee, who have just said basically, nothing to see here, let us move on when it comes to this concern.

So I wanted to ask Mr. Carfang first, sort of following up more particularly about the corporate bond market and the liquidity concerns there, and if you could respond directly to what Mr. Green has laid out in terms of whether or not we should be concerned about this liquidity and specifically as it relates to the things that you have laid out in your testimony that suggest otherwise?

And then, I would like to hear from Mr. Plunkett on this as well, when you are finished.

Mr. CARFANG. Sure. Mr. Green's facts are correct, but his conclusions are wrong.

Mr. HURT. Explain that more.

Mr. CARFANG. We have a Federal Reserve that has inflated its own balance sheet from $1 trillion to $4 trillion over the course of the financial crisis. That completely disrupts the financial markets in a way that reduces interest rates.

So when Mr. Green says borrowing costs are at an all-time low, well, yes, but that is Fed-induced, not market-induced.

When the Fed unwinds its balance sheet, frankly no one knows. And that is going to be another chemical put into the experiment.

Our clients, particularly those who don't have the highest credit rating, are having difficulty raising cash, or raising cash at rates that make sense for them to create jobs and expand their businesses. That is true for our corporate clients, and that is true for municipalities and State governments as well.

Mr. HURT. Do you think that if the Federal Reserve raises rates in the future, it will exacerbate this problem? And where does systemic risk fit into all of this?

Mr. CARFANG. I am not sure that it will exacerbate the problem. I think if the Fed allows rates to settle where they would naturally settle in the marketplace, we would have the most optimal results.

Mr. HURT. Okay.

Mr. Plunkett, I'd love to get your thoughts on this.

Mr. PLUNKETT. I am not prepared to speak in any detail on this subject, but we do hear from our asset management firms that the liquidity in the fixed income market has certainly changed, and not for the better.

The one point I might add is that when we talk about the number, the amount of corporate bond issuances, it might be linked to the fact that investors are searching for yield and it is a zero interest rate environment. So people are certainly going to, companies are certainly going to go out and tap that zero interest rate environment as much as they can.

Mr. HURT. Excellent.

Mr. JOHNS. There is one thing I might just sort of add, too.

Mr. HURT. Mr. Johns, please?

Mr. JOHNS. I don't know if the corporate bond market is the right place to have our focus here. If we are looking at the impacts of Basel, that is not the corporate bond market. You need to be looking at the financial industry, the securitization industry, and anything that is impacted from a banking regulation perspective.

I could be a pharmaceutical company issuing corporate bonds. I don't know how Dodd-Frank and how Basel regulations necessarily are going to impact that.

So it may be true that there is more issuance in corporate bond space and that may ultimately create some element of corporations being able to fund themselves.

But if you are looking at the main mechanism of delivering funding to the real economy, look to the financial sector, which is not necessarily the same thing as the corporate bond market.

Mr. HURT. Mr. Renna or Ms. Coffey, do you have anything to add?

Ms. COFFEY. The one thing I would add to that is we are talking about interest rates being at all-time lows for companies.

It is important to remember interest rates are comprised of two components, the base rate, the Treasury rate, or LIBOR, which Fed monetary policy has reduced very substantially, and it is also composed of the spread. The spread over those base rates is extraordinarily high right now and that is something that we do need to bear in mind.

Mr. HURT. Thank you.

Mr. Chairman, I yield back my time.

Chairman GARRETT. The gentleman yields back.

Mr. Hinojosa is recognized for 5 minutes.

Mr. HINOJOSA. Thank you, Chairman Garrett and Ranking Member Maloney, for holding this timely hearing.

I also wish to thank our distinguished panel of witnesses for their appearance and testimony today.

Although more than 7 years have passed since the height of the financial crisis, we continue to feel its aftershocks reverberating through our economy and financial system.

We have seen troubling episodes of increased volatility and less liquidity in our markets. So as we examine the health of our capital markets, we should take a good look at not only the possibility of intended consequences of regulations, but also look at how the fundamental structure of our markets have changed.

A myriad of factors are contributing to this volatility. And we should be wary of claims that regulations are not having any effect.

Moving forward, we need to ensure that our legislative efforts provide for a vibrant market without undermining the safety and soundness of our financial system.

My first question is to Mr. Stanley. According to the bond market liquidity reports issued quarterly by the Fed, the FDIC, the OCC, the CFTC, and the SEC, liquidity in both primary and second markets remains strong. However, we have had several episodes of market volatility and signs that the market depth has shallowed in the bond market.

Do you think our bond markets are healthy and would remain resilient in the face of market stress? If so, please explain.

Mr. STANLEY. There are these concerns, as you say, that, and this relates to this issue of smaller trade sizes that I mentioned, that the higher capital ratios on the big dealers have made markets shallower.

I think that at this point, these concerns are very hypothetical. I don't think that they have been proved out in terms of anything that has actually been seen in the financial markets. It is the regulators' job to worry about these possibilities in the future.

I think that the gains that we get by ensuring that the major dealers are at the center of the system are well-capitalized and don't borrow excessively are much greater than any potential slight increase in spreads that could occur from shallower markets.

One thing that we saw in the crisis clearly was that when those dealers are over-leveraged and when they are impacted, when they have to engage in fire sales and prices drop, that the negative impacts are just absolutely enormous. And it is crucial to protect against that.

Mr. HINOJOSA. Mr. Stanley, if that is so, have the regulatory changes made by Dodd-Frank negatively impacted the bond market liquidity?

Mr. STANLEY. I don't believe that they have. People point to a drop in bond market inventories at the major dealers are somehow being problematic. But as I say, I think that these make these dealers—first of all, I think that those changes emerged coming out of the crisis. They predate Dodd-Frank.

And I think that to the degree those changes are because the major dealers actually have to hold real capital against their balance sheets as opposed to borrowing, I think they make the markets more stable and durable.

Mr. JOHNS. That is not something that we have seen evidenced by the market. I would say that at crisis and immediately post-crisis, you might have had a dozen dealers that had the capacity to take maybe a billion dollars down onto their balance sheet. Now, maybe that number is three.

You are seeing inventory go down. I think Steve and Meredith and, sort of, Anthony, just commented on this. RMBS, CMBS, dealer inventories are down about 50 percent in the last 2 years.

So, we are seeing something. This is not hypothetical.

Mr. HINOJOSA. Let me hear from Mr. Green.

In your testimony, you mentioned that the electronification of the bond markets in the past have been dominated by the large bank dealers and that is changing the characteristics of those markets.

To what extent did Dodd-Frank and Basel capital requirements interplay with the increasing effects of the markets?

Mr. GREEN. I think that there are important technological changes going on in the markets. We are seeing increased

electronification, especially in the Treasury markets. That is a function of changing technology, and frankly is not a function of regulation.

And frankly, it is something that folks on both sides of the aisle have seen offers potential for good, folks like former SEC Commissioner Dan Gallagher has called for great electronic trading of bonds. So, it is not a problem; it is something that the regulators need to pay attention to.

If I can just briefly respond to the point about inventories, inventories were at their height in the run-up to a during the financial crisis, and that resulted in massive losses in failures to the largest financial institutions around the world.

The decline in inventories and the increase in capital means that dealers are actually now positioned to take on inventories when it makes economic sense, when the market-making makes sense and so that they are capitalized to absorb the risks that they are going to take. That is what we mean by—

Mr. JOHNS. That is simply not true.

Chairman GARRETT. Time has expired.

Mr. JOHNS. That is simply not true. That is not—cause-and-effect don't work that way. It is not that they have now positioned themselves deliberately because of the capital they are holding. That is not how capital works.

They have dropped their inventory because of the fact that they have these capital charges associated with their inventory positions.

Chairman GARRETT. Thank you.

Mr. HINOJOSA. I yield back.

Chairman GARRETT. Thank you.

Mr. Duffy is recognized for 5 minutes.

Mr. DUFFY. Thank you, Mr. Chairman.

Mr. Carfang, what role did profit trading have in the financial crisis?

Mr. CARFANG. Banks trade for their own portfolios and they do that primarily to accommodate their customer activity as well as profit themselves.

Mr. DUFFY. Was it a root cause of the financial crisis?

Mr. CARFANG. Absolutely not.

Mr. DUFFY. I would agree.

So would you agree that the Volcker Rule caused a reduction of providers and sources of liquidity in fixed income securities?

Mr. CARFANG. Right. I believe the Volcker Rule has caused less trading and, therefore, wider spreads.

Mr. DUFFY. And so now, where does that new liquidity come from?

Mr. CARFANG. The liquidity comes from banks and it comes from other participants in the capital market.

Mr. DUFFY. Maybe this is to Ms. Coffey, as well. Do either of you see any additional downside risk with these new liquidity providers at times of market stress?

Ms. COFFEY. Absolutely. One of the things that you need to think about is, do you have two-way liquidity or do you have one-way liquidity?

What is very important with market makers is that they provide two-way liquidity. They will buy and they will sell. When you have many market participants, they might all be buying or all be selling at the same time and that is something very important to bear in mind.

Mr. DUFFY. Okay.

And Mr. Carfang, I think you made an interesting point in regard to the high school chemistry set. You might see one potion or powder and how that behaves in its vial by itself, but when you put all three vials together, we actually don't know what happens.

So if you look at risk retention, Basel and Volcker, do we actually know the consequence on our markets with these three combined?

Mr. CARFANG. What we are seeing with these three combined is those institutions of the absolutely highest quality have liquidity, they have low spreads, they have inventories, and they have traders in their securities, but everyone else is being crowded out.

Mr. DUFFY. Yes.

Mr. CARFANG. All but the highest-quality borrowers have access now.

We see—Basel III is what we refer to as being procyclical, so when things are fine, the markets are not in stress, there is plenty of capital, there are low rates, low spreads, but in times of stress, Basel III actually requires banks to hold more liquidity, more Treasury bills. And—crisis when we do have markets in greater stress.

We don't know, we haven't seen how the markets and how this chemical reaction is going to take place when you add financial stress, you add the Fed unwind and a number of unknowns that are still playing out.

Mr. DUFFY. Have we seen any warning signs when we look back to October or to August of this past year when we have any market stress and what happens to liquidity?

Mr. CARFANG. We had the Treasury flash crash, but we are also seeing pockets of illiquidity in the municipal bond market from time to time. And we are seeing trading gaps because of very high volatility. Big fluctuations in price are the result of low inventories and wide spreads.

Mr. DUFFY. So you guys are all aware of Lord Hill, Jonathan Hill from the EU, and they have actually taken a pause or recommended a pause in the EU because I think there is an understanding that we don't know, like your chemistry set, the consequences on our markets, our economy, on our growth that all of these rules are going to have on one another.

Is there something that we know on why all these rules are going to work that the Europeans don't know? Is there something they know that we don't know?

Mr. CARFANG. In the early part of the decade after the crisis, there was a regulatory arms race. Other central banks are taking a pause; we are not.

Many of the regulations are actually improving the safety and soundness of the system. I am not here to advocate against, that these regulations be ripped apart.

But it is that chemical reaction, that we haven't taken a deep breath and we haven't stepped back to understand what all these unintended consequences are.

When a municipality can't sell a note to a money market fund to meet a payroll, that is a problem.

Mr. DUFFY. Ms. Coffey, would you agree that we don't know the consequence in times of market stress as to how all of these rules are going to impact on markets?

Ms. COFFEY. Absolutely. I would say there are more than three chemicals and I certainly hope nobody blows up the school.

[laughter]

Mr. DUFFY. Is it possible the school gets blown up here?

Ms. COFFEY. I certainly hope not. But I think there are definitely questions that when you start layering all these different factors on top of each other, nobody knows how it turns out.

Mr. CARFANG. At the margin, behavior changes. And yes, there will be a school that is not built. There will be a hospital that is not built.

Mr. DUFFY. Very quickly, did mortgage-backed securities have anything to do with the crisis? Did that have anything to do with Dodd-Frank? And does anyone know if there was any reform to Fannie Mae and Freddie Mac in regard to—

Chairman GARRETT. Quick answer.

Mr. RENNA. Residential mortgage-backed securities were at the heart of the crisis, Congressman.

Mr. DUFFY. And were Fannie and Freddie part of our mortgage-backed securities?

Mr. RENNA. Certainly, they were encouraging a lot of federally-guaranteed mortgages.

Mr. DUFFY. And was there any reform to Fannie and Freddie in Dodd-Frank, do you know?

Mr. RENNA. No, there was not.

Mr. DUFFY. I yield back.

Chairman GARRETT. Okay, I will.

Mr. STANLEY. Can I just jump in on the question as to—

Chairman GARRETT. No, I am going to try to keep it even, and give the gentleman from California another 20 seconds, too, on the end of his, so we stay. But thank you.

The gentleman from California is up for 5 minutes.

Mr. SHERMAN. I thank the chairman and the ranking member for having these hearings because there is far more money involved in the bond market than the stock market. And whether American businesses can provide jobs and expand depends I think, a lot more on the fixed income or debt instruments.

What is missing from the panel is the bond rating agencies which, I think, are almost entirely responsible for the 2008 collapse. They gave AAA to Alt-A.

I have talked to people who put together mutual fund portfolios. And they say, how can I not have the highest yield with the highest rating? If I turn down a AAA-rated security that pays five basis points more than some other AA-rated security that I think is more sound, then people look at the portfolio and they just say I have five basis points less.

Who is going to invest in a mutual fund that pays five basis points less?

So the credit rating agencies are the only way for the individual investor to evaluate a portfolio. I have had people in this room so desperate to defend the credit rating agencies that they say in valuing a bond portfolio, don't pay attention to the credit rating. These, of course, are the credit rating agencies whose last refuge is to say, don't pay attention to what we say because you know we have been paid to say it.

I would not attend a baseball game if the umpire was selected and paid by one of the teams.

But we have covered in this the credit risk that individual investors face and risk retention may focus on that. We haven't talked at all about the interest rate risk.

We have lived so long in a zero inflation world or 2 percent inflation world that we have forgotten the 1980s.

Retired people are stressed by the low nominal rates they are getting. And at 8 percent, if they were getting 8 percent on their money in a 6 percent inflation world, they would be happy. They would be eroding their capital by 6 percent a year, but they wouldn't notice. They live in a nominal world; the people in this room live with real interest rates.

But now they are getting 2 percent in a zero percent inflation world, or 3 percent or a 1 percent inflation world, and they are desperate to get a higher nominal rate, and they are playing with high-risk yield. And they may be driven to take credit risks, but they also may be driven to go out longer and take a bigger credit risk.

Let me ask Mr. Johns, is there a market for, and are people issuing, other than TIPS, inflation-adjusted debt securities for people to buy, other than the Federal Government's TIPS program?

Mr. JOHNS. From a securitization perspective, I am not aware of anything.

Mr. SHERMAN. Okay.

Ms. Coffey?

Ms. COFFEY. I would note that non-investment-grade loans are actually tied to a 3-month LIBOR; therefore, they are floating rate and are not—

Mr. SHERMAN. I missed the first part of your answer. What is the type?

Ms. COFFEY. Non-investment-grade loans, the loans that finance companies like Cable Vision and Dunkin Donuts, are floating rate instruments—

Mr. SHERMAN. They are regarded as high risk because you are not sure Dunkin Donuts is going to sell enough donuts, and yet the 30-year Treasury may be the thing that loses half your money for you. Because if we live in—I haven't done the calculations, but if we go to 10 percent inflation, I assume the 30-year Treasury loses, what, about half its value?

So you can lose half your money on a Treasury, and it may be safer to buy the donuts.

Ms. COFFEY. Certainly if I am the consumer of the donuts.

Mr. SHERMAN. Is anyone else on the panel aware of floating rate instruments and/or inflation adjusted instruments?

We should talk about my mother's portfolio.

What is being done to—are we doing enough to warn individual investors about the interest rate and inflation risk?

Mr. Green?

Mr. GREEN. If I could add on that, I think that transparency is the key here. In 2002, FINRA introduced the TRACE reporting system, which brought down costs significantly in the fixed income markets.

There is a lot more we can do. There are proposals out there that are expected to move forward regarding—

Mr. SHERMAN. Do any of their proposals account for the fact that in an absolutely transparent 30-year Treasury bond that everybody thinks is super secure, you can lose half your money if there is a change in the inflation rate? What can we do to warn people more of that interest rate risk? Because they live in a world where they think the 30-year Treasury is really safe and the donuts aren't.

Is there anything else we can do to warn people of the interest rate risk?

Mr. GREEN. I would absolutely agree that there is more.

Mr. SHERMAN. What do we do?

Mr. GREEN. We need to increase the disclosures and the financial education. There is a lot more that the investment advisers—

Mr. SHERMAN. There is no risk statement on the 30-year Treasury.

I yield back.

Mr. HURT [presiding]. Thank you, Mr. Sherman.

The Chair now recognizes Mrs. Wagner for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman.

Thank you all for joining us today to discuss some important regulatory issues facing our fixed income markets, which are vital for keeping the cost of credit down for consumers and for businesses.

In addition, if and when, as we are discussing, the Federal Reserve continues to raise interest rates beyond what they did in December, that will apply further pressure on this market, which will require a strong framework and measures to ensure that there is enough liquidity to continue trading these securities.

As we have already seen, Dodd-Frank has greatly weakened the ability of participants to react to market events, from the Volcker Rule to new risk retention provisions that will go into effect later this year.

Ms. Coffey, while the financial crisis was largely a result, as we have discussed, of non-performing loans in the residential mortgage space, how did the loans that this risk retention rule target fare during the financial crisis?

Ms. COFFEY. Certainly. One of the things to bear in mind with these non-investment-grade loans is that they are senior-secured. So first of all, the companies tend to perform very well and worked through the financial crisis well.

And secondly, even if a few of the companies did default, the recovery, given default, was extraordinarily high, more than 80 cents on the dollar.

As a result, investments that invested in these structures, like CLOs, performed extraordinarily well, had de minimis default

rates, even lower default rates than we saw on investment-grade corporate bonds, for example.

Mrs. WAGNER. They performed extraordinarily well, yet the risk retention rules don't seem to acknowledge the fact that these securities performed extraordinarily well, which, as you noted in your testimony, helped finance more than 1,200 companies that employ more than 6 million people.

Why is that?

Ms. COFFEY. So why did it not—why does risk retention particularly hit CLOs?

Mrs. WAGNER. Yes.

Ms. COFFEY. I think in part it is because of the bad acronym. People see CLOs, they think CDOs, and they don't take the time to separate out that CLOs actually provide financing to American companies. I think that is the big difference.

We spend a lot of time talking to the agencies and speaking with lawmakers about structuring a way to have risk retention that fully comports with the Dodd-Frank Act, but that would still permit CLOs to continue to survive, and that is in H.R. 4166.

Mrs. WAGNER. Right.

Ms. COFFEY. We think that is a good solution.

Mrs. WAGNER. Great.

All right, Mr. Johns, despite the past performance and strong fundamentals of many of these loans, our regulators categorically decided that any asset-based security does not qualify as a high-quality liquid asset. Why is this the case?

Mr. JOHNS. I think it is an over-exuberance of regulation in the short basis. I think it is a failure just to recognize that while we represent issuers and investors, some investors are obviously in favor of risk retention, issuers fear the capital burden as a sort of ebb and flow and push and pull of opinion there.

But what is clear to me is that from these changes, whether it is Dodd-Frank or the changes that you see in Europe that are very similar to Dodd-Frank in securities land, there are some positives that have come out of here.

You have risk retention, you have increased disclosure. You have changes to the rating agency process. There are a lot of things that, whether you agree with the degree of it or not, some good has come out of it.

So what I can't understand is why if you are Basel, or if you are one of the joint agency regulators, why you are not rewarding good behavior.

I think the reference to insurance was put out earlier today. Think of capital like insurance. Your insurance premiums go down if you are a good driver. So if you are putting in place aspects to your program that actually make it a safer product for investors, that make it more transparent, that there is increased risk retention, whether you agree with the risk retention or not, at least reward that behavior by making sure that it is treated as liquid.

I am hearing these guys saying here that we don't have a liquidity problem. Well, if we don't have a liquidity problem, why on earth can't we treat these as liquid assets?

It makes absolutely no sense to me how the two gentleman to my right and left here are telling me something that I am actually say-

ing, yes, we have an issue with liquidity with the capital, but the actual liquidity in the nature of the asset itself should be rewarded.

Mrs. WAGNER. Mr. Johns, just in my limited time, I have to close, what are the real-world consequences of reduced liquidity in the corporate bond market for U.S. companies, their employees, and individuals saving for retirement or to send their kids to college? Why does this matter? Quickly.

Mr. JOHNS. Ultimately, it means that money is not being lent to folks who need to deliver that money to the real economy.

Mr. HURT. Thank you.

Mrs. WAGNER. I appreciate it.

Mr. HURT. The gentlelady's time has expired.

The Chair now recognizes Mr. Lynch for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

I thank the ranking member—and the panel this morning.

Let me take the small problem I have.

And Mr. Plunkett, you have this naming problem that seems to be uniquely affecting Natixis and nobody else. Can I ask you, have you tried to resolve this in a regulatory setting or administratively? Or do you think that legislation is required?

Mr. PLUNKETT. Thank you, Representative Lynch.

We have talked to the regulators about it and they were very clear. We even submitted a formal request for guidance in our particular situation. And they were very clear that they felt that there was no flexibility in the Volcker Rule legislation for them to regulate.

Mr. LYNCH. Okay, okay. I am good, okay. I agree with you, and maybe we can fix that in one of the bills coming up.

Let me ask you, Mr. Stanley and Mr. Green, there is rather a benign view of CLOs this morning. I was here during the crisis, and even though the 10-year average might be good, during that stress period, we had some problems.

The fact that the taxpayers pumped $970 billion into the markets and we created a commercial paper facility and did all these things to kind of prop things up, did that have anything to do with the relatively better performance of CLOs?

Mr. STANLEY. Absolutely. There was trillions of dollars of public liquidity support into the market during the crisis. So you can talk about the relative performance of different assets, but I don't think that you can say that any asset is totally healthy on its own without that kind of support.

And I would just also say that the CLO market was very different in 2007 than it is today. In 2007, less than 30 percent of CLO loans were what is called "covenant light," which is more dangerous in terms of paying back. Now, over 70 percent are.

And we have seen enormous increases in the issuance of CLOs in the reach for yield environment created by low interest rates. We have seen very compressed spreads on these high-yield loans.

So I would ask the other panelists here, would you feel more comfortable if our banks were loaded up with these CLOs that are currently dropping in value in the market? As the Fed started to raise interest rates, would you feel more comfortable about the state of the financial system?

Mr. LYNCH. That will have to be a rhetorical question because you will take all my time.

Mr. Green, anything else to add?

Mr. GREEN. I would add that the leverage loan market was the corporate—the last financial crisis, the corporate performance was not at the heart of it, but if we look around the world there are a range of financial crises, look at Japan, where corporate loans drove failure there.

So we have to be on guard for the whole range of these things and that is where regulators have been calling out the leverage loan market which is what is a lot of—

Mr. LYNCH. Let me drill down on it a little bit more.

At the core of the failure, though, was the issue of securitization for distribution where folks could just pump out these securities and escape any type of skin in the game or any type of negative consequences of pushing them out in the market.

H.R. 4166, the new bill here that is being pushed with respect to—H.R. 4166 suggests that for a hundred million dollar issuance, there would only be $400,000 of negative consequence to the issuer. Now, isn't that a furtherance of sort of no skin in the game, just pushing? That is the stuff that got us in trouble in the first place.

Mr. STANLEY. Absolutely. I think it just totally undoes the positive incentive effects that were intended to be created by risk retention.

And if you look at the CLO market right now, there was a recent JPMorgan study which found that over half of the mezzanine-level tranches of CLOs—this is not the equity; this is mezzanine-level tranches—were showing mark-to-market losses. And that is an increase from less than 1 percent in September 2015.

So this is a market that is under stress. It can show losses. We need to have the right incentives there.

Mr. GREEN. And if I can add to that?

Mr. LYNCH. Sure, please.

Mr. GREEN. What we see in Europe with Lord Hill hitting a pause on better capital performance with a simple transparent comparable work they are doing there, it is actually not necessarily leading to better results. We see European banks taking a bloodbath on their stocks. U.S. firms are holding up because of the strength of our regulation.

Mr. JOHNS. STC hasn't been implemented in Europe, so it is irrelevant.

Mr. LYNCH. Reclaiming my time, please, I yield back. Thank you.

Mr. HURT. The Chair now recognizes Mr. Poliquin for 5 minutes.

Mr. POLIQUIN. Thank you very much, Mr. Chairman. I appreciate it.

And thank you all very much for coming here today. This is a really important education for a lot of us.

Everybody in government should do everything humanly possible to help our companies grow, whether here in Washington or in the State or the local government. Right? We are all here to help.

And when you have companies that are able to grow and hire more workers and pay their workers more money, you have less people dependent on the government.

I come from Maine. You know, we are pretty tough and resilient up there. And I mean the real Maine, western, northern, central and down east Maine, not northern Massachusetts. I mean the real Maine. And we like to consider ourselves independent.

So I am looking at this whole problem of liquidity and volatility in the financial markets, in particular the fixed income market, and when you have lots of volatility and wide price swings, probably brought on or arguably brought on by a lack of liquidity in the market because of these smothering financial regulations, there are two things.

First of all, companies who decide to access the capital markets to borrow by selling bonds so they can grow and hire more workers instead of borrowing from a bank or a credit union, well, they have less opportunity to do that, so there is less opportunity to grow and for our economy to grow.

And also for our seniors, who are using fixed income investments as a stability against an equity portfolio, they get discouraged also.

So my question to you is the following, and Mr. Carfang, I would like to address this to you. I am looking at FSOC. This is a group of regulators, some of the biggest, heaviest, most in-the-weeds regulators we have in the world are on this board. And they pick apart all the different players in the asset management space, all the different players in the insurance space. And they say, are these folks too-big-to-fail?

I came from the money management business. And I will tell you, if you and I are competing, and you are managing pension funds and I am managing pension funds, and my performance is better than yours, then your clients are going to come to me. And if you get in trouble, you represent absolutely no systemic risk to the market because the assets are held at a custodian bank; we are agents.

What systemic risk do we provide—now, I am looking at this whole thing that FSOC is doing. Why in the world should they be spending their time looking at fixed income market risk? When you have less liquidity in the fixed income market, isn't that systemically risky to the economy, into the financial markets and our ability to grow as a country and provide more opportunities for people? What do you think of that, sir?

Mr. CARFANG. I think the FSOC actually creates double jeopardy and creates a culture of indecision on the part of our financial institutions and the investors.

Financial institutions are not only subject to their specific regulators, but should FSOC not like the outcome that the regulator has, they have a second bite at the apple. And that absolutely slows down our creativity, it slows down economic activity, and job creation.

To me, the FSOC is probably one of the most serious problems that we have in the sense that they are overreaching now into asset management and things that have absolutely nothing to do with truly systemic risk.

Mr. POLIQUIN. Why doesn't the SEC focus on that? The SEC has been overseeing asset managers for 80 years. They do a pretty good job, don't they?

Mr. CARFANG. They have a tremendous track record. The SEC in fact was working on money market fund regulation that I spoke to in my testimony and was ultimately sort of strong-armed by FSOC into coming up with the regulations that are now damaging the tax-exempt and prime markets.

Mr. POLIQUIN. Thank you, Mr. Carfang.

I think this is an example of big, heavy, intrusive government, the Administration's financial regulations that are smothering.

We are the envy of the world. We have the best capital markets in the world, most diverse, most liquid, deepest. Why do we want to destroy that?

I would like to move on, if I can, to you, Mr. Plunkett. And I want to make sure I understand this.

You were mentioning H.R. 4096. Now, you folks, your organization, Natixis—am I pronouncing it correctly?

Mr. PLUNKETT. Yes.

Mr. POLIQUIN. Natixis. I am pretty close, I am from Maine so we do the best we can, unlike the folks from New Jersey.

But in any event, you are a French bank or your holding company is a French bank, and you own asset managers here in America, including Loomis Sayles, I believe.

Mr. PLUNKETT. That is right.

Mr. POLIQUIN. That has been around forever, right? So I am an investor, and I am a retired auto mechanic from Bangor, Maine, my wife's a nurse, and we are putting aside 50 bucks a week or a month to save for our retirement. And we want to hire Loomis Sayles.

Shouldn't I want all the information humanly possible to know that the brand, the name and the company that I am hiring, I have all that information?

Now, talk to me a little bit about the naming problem here that H.R. 4096 is trying to correct.

Mr. PLUNKETT. 4096 is trying to simplify the communications between the manager and the end investor and make it really clear from the beginning which manager is managing which fund. It is just trying to simplify and make more transparent.

Mr. POLIQUIN. And that is really important, right? Okay. Thank you very much.

Thank you, Mr. Chairman.

Mr. HURT. The gentleman's time has expired.

The Chair now recognizes Mr. Hill for 5 minutes.

Mr. HILL. Thank you, Mr. Vice Chairman. I appreciate the topic of this hearing.

We are here because we keep having testimony on monetary policy in this committee, and yet all of our regulators, when we talk about monetary policy, we are at zero and we still have an economy that is sub par and not growing and capital is not being allocated.

So I am glad we have a hearing today that talks about non-monetary policy's structural impediments to economic growth, which is what I think the topic is today.

We want to encourage private capital flows into institutional, corporate-grade, commercial real estate. These products are for institutional investors. And I think that is something that all of the members of the committee understand.

We are talking about institutional products here, not products being marketed to retail investors.

And secondly, my view in looking at the proposed rules on commercial mortgage-backed securities, private capital flows will be severely curtailed under the proposed regulatory rules that are being considered, and they are on top of the existing portfolio and Basel capital rules that our panel has talked about.

Also, when I look at this topic, the regulators' proposals for residential mortgage-backed securities are generous, and yet they were at the heart of the crisis.

And yet in the qualified approach to residential mortgages, 85 percent would qualify. But for commercial mortgage-backed securities, around which there was no demonstrated contribution to the crisis, these proposed rules will only have 3 to 8 percent of the market qualify. And that is back-testing from 1997 through 2013 or so. So that has to raise concerns that we are hurting private capital flows and that we are not being fair and balanced as it relates to the commercial market.

If you look at default rates, which to me is the stress test, who needs a stress test when we have been through the market that we have been through? So we have it, we have the data.

And on the subject of single-asset, single-borrower securities, which is partially addressed in my draft, they only had 25 basis points as a historical loss ratio over that back-testing period.

And if you include even 2007, which was the worst year, it was 1.77 percent as a default rate, which still, in the great scheme of life if you are in the real world, not the academic world, is a pretty good default rate.

I also read in the Democratic comments in the packet today that somehow people are concerned about cross-collateralization, that somehow that is a bad thing.

I can tell you, as a banker for 35 years that is a dream thing, that is a good thing to have a single-asset, single-borrower entity that is cross-collateralized because it actually is in the creditor's favor and reduces the possibility of collapse of that asset category, not enhances it as argued in a memorandum from the opposition.

And then finally, I am curious about the proposed rules for commercial mortgage exceptions, that they are just—I don't know how they came up with these rules.

Some of the parameters that we talk about in my draft might be appropriate in a community bank loan to an individual borrower, but they don't reflect the institutional market for commercial mortgage transactions, and so they don't seem to be well-placed. And I am sure we will have more conversation about that.

But I would like to ask a question of—insert itself in this setting the rules, if you will, in trying to determine this qualified rulemaking. Because this has been going on for 2 years. And I am trying to explain what interaction you have had with our regulators, what data you have provided them. Could you give us a snapshot of that, please?

Mr. RENNA. Absolutely. Thank you, Congressman. You did a terrific job summarizing what is going on in the CMBS industry.

With respect to why we are here asking Congress to intervene is that, one, as I said in my opening statement, we acknowledge

the daunting task that regulators had to administer Dodd-Frank and particularly with respect to risk retention. They told us we would love one broad-based, elegant rule that applied to all asset classes. That would be the simplest way to do it.

Unfortunately, the world is not a simple place. There are many different types of asset-backed securities, CMBS is just one of them. They all have their own characteristics.

What we tried to demonstrate to the regulators is that the way to achieve your risk retention goal, yet allow the industry to function as efficiently as possible, would be to accept these certain modifications we are requesting in our comment letter to you. And one of those was with respect to exempting single-asset, single-borrower from risk retention for the basic and simple reason that it is not a conduit security.

Chairman GARRETT. The gentleman's time has expired.

Mr. HILL. I yield back.

Chairman GARRETT. Mr. Scott? I believe you passed before you—

Mr. SCOTT. Yes, thank you.

Chairman GARRETT. All set?

Mr. SCOTT. Yes.

Chairman GARRETT. Okay. The gentleman is recognized for 5 minutes.

Mr. SCOTT. Thank you.

Mr. Renna, let me ask you, because maybe the general public, those watching on C-SPAN, really need to get a good understanding of the difference between commercial real estate and residential real estate. And where is that differential balance then?

Mr. RENNA. Thank you, Congressman. It is very simple. A residential mortgage loan is underwritten based on the credit quality of the borrower. They are going to look at how much money do you make, how much do you have in your savings, and determine whether they are going to make a loan to you for a home mortgage.

With respect to commercial financing, they are not looking at the borrower to underwrite the loan, they are looking at the asset and the cash flow that comes from the various tenants that are within that asset, and then also the unique characteristics of that particular building. How old is it, how technologically modern is it, other factors that will go into determining whether it is qualified for a loan, for a mortgage to be applied to that asset, not to the borrower.

Mr. SCOTT. I am very concerned that we continue to make sure that businesses in the commercial market have access to a variety of financing options.

So let me ask you if you can expand upon, you are familiar with, I guess it may have been—I'm sorry I didn't get into the meeting, I had another one—but the CLOs. Right? You are familiar with the CLOs, is that correct? Are you?

Mr. RENNA. I am familiar, but I am not the expert that people on the panel are with respect to CLOs.

Mr. SCOTT. Okay. So let me ask you this: How are our government regulations making it more difficult, in your opinion, for commercial real estate?

Mr. RENNA. Basically, there is kind of a piling-on effect of a number of regulatory initiatives that are requiring the holding back,

the reserving of capital against commercial against commercial loans that lenders make.

In addition to that, it is the uncertainty in how it applies. So it is the amount of capital that the regulations require lenders to hold with respect to making a loan, and it is also the uncertainty as to how the rules apply. Risk retention is an example of that.

The regulators were very broad in discussing how risk retention is to apply so now the industry has to figure out how we comply with that. There are many, many open questions to that.

So what we are asking for from the regulators, and now we are asking for from Congress, is some specific guidance with respect to helping us on the most important issues that will allow the market to operate efficiently.

Mr. SCOTT. Risk retention, I got it.

Ms. Coffey, I want to talk a little bit about the CLOs. I am working with my Republican friend, Mr. Barr, on a CLO bill, House Resolution 4166, the Expanding the Proven Financing of American Employers Act.

So tell me, why do we need this Act? Why do we need this bill?

Ms. COFFEY. Absolutely. Thank you very much, Congressman. We need this bill for a couple of reasons. First of all, the risk retention rule, as it is written, is extremely, very much over-broad.

What the Dodd-Frank Act said is that the securitizer must retain 5 percent of the credit risk of the assets being securitized. The way the final rule is written is that regardless of what the assets are, the securitizer must retain 5 percent of the full amount of the securitization. That is not 5 percent of the credit risk. Five percent of the credit risk is a much smaller amount.

If we could move it, the amount that is 5 percent of the credit risk, which H.R. 4166 does, then smaller managers will be able to continue to provide financing to U.S. companies.

I will give one quick example. In 2014, 30 managers accessed the CLO market, and issued CLOs. These managers were not able to issue CLOs in 2015 all due to risk retention looming. That is a problem. We can resolve it with H.R. 4166.

Mr. SCOTT. Both Representative Barr and myself feel the passage of this bill will help increase jobs. Do you agree with that?

Ms. COFFEY. I absolutely do. It will continue providing financing for important U.S. companies. Without that financing, those companies cannot grow and cannot continue to create jobs.

Mr. SCOTT. Thank you very much.

Thank you, Mr. Chairman.

Chairman GARRETT. Mr. Schweikert is recognized for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Mr. Johns, first of all, I am going to have all my interns read your written testimony. It is well written.

In both your verbal testimony and here, you have had a conversation about, okay, how about the contract obligations? We are talking about risk retention, I want you to go into that a little bit more—the opportunity to say, okay, here is what the review of our trading book says. What can you contractually also, by hedge, by an additional insurance on that risk?

Mr. JOHNS. Okay. So the point about contractual obligations is when you look at a securitization contract, ultimately it transfers

risk to investors. I don't think you can argue that transfer did occur. If you look at the losses that investors took during the crisis, it is pretty well-documented that investors did take losses.

When FASB brought back these transactions on balance sheet, which I don't think were necessarily objective to disclosure of the obligations, I think generally is a positive thing; the issue you get is that you are now disclosing something where the risk has been transferred. And capital rules do not allow for recognition of that difference.

So you end up, from an accounting perspective, creating loss reserves. And you hold capital gains.

Mr. SCHWEIKERT. It is important to say that maybe one more time: Risk isn't transferred, but yet you are still carrying it under your accounting rules.

Mr. JOHNS. You have transferred your risk, you have no contractual obligation to take that risk down, and yet you are still holding capital gains.

Let me give you some numbers here. If you look at the crisis, if you are a credit card, losses generally track unemployment rate up until a point because a credit card only has a life of about 8 to 12 months. So if you are more than a year into a crisis, you have already seen tightened underwriting manifest itself in the performance of credit cards.

But let us say you are at 10 percent. Say, unemployment in the last crisis went past 10 percent. Your losses may track up to that. At the same time, you are being asked to hold 10 percent capital against that risk.

So now, if you look at the combined effect on your capital position through a write-down on your equity by providing loan loss reserves and the 10 percent capital you have to hold, now you have 20-something percent.

If you equate that to what that means for unemployment, you are really talking about 25-plus percent, which the last time we saw 25 percent unemployment was in the Great Depression, not the Great Recession.

Mr. SCHWEIKERT. Okay. So the point is pretty simple, hopefully, for everyone here. Whether it be in automobile, floor plan, or credit card, you have already transferred the obligation or the risk portion of the paper, and now under Dodd-Frank, we are asking you to retain something that you have already transferred.

Mr. JOHNS. Exactly. So even if you are a regulator saying, well, we have to hold capital against the unexpected loss, if you are an accountant, how can you say the expected loss is actually assuming that you are going to unilaterally break the contract that you have with an investor?

That, to me, doesn't make any sense at all. And it is penalizing the economy in terms of billions of dollars that could be released back if you release that equity.

Mr. SCHWEIKERT. Yes. And it is paper. It is basically a paper obligation you are carrying on your books that you can no longer put out on the street.

Mr. JOHNS. Correct.

Mr. SCHWEIKERT. I have always wanted to touch on your ability for that paper obligation, even though you have actually already

transferred it with those who chose to purchase the bond, is it hedgable, what is on your book? Could you buy an insurance product on it? And would that be accepted?

Mr. JOHNS. Technically, I think yes, it is. I would have to go back to our members and sort of talk about how you could hedge that. I don't really want to get into the world of credit default swaps in front of this audience right now.

Mr. SCHWEIKERT. But my understanding is the regulators would not give you much credit for having lost that.

Mr. JOHNS. Correct. That is correct.

Mr. SCHWEIKERT. So even if you were to add that additional layer because of your paper obligation, you still don't get much benefit to it.

Mr. JOHNS. It wouldn't make a lot of economic sense.

Mr. SCHWEIKERT. Also, in your written testimony you actually do touch on a common securitization platform. In the last 20 seconds, tell me why it is wonderful.

Mr. JOHNS. Sorry, say that again?

Mr. SCHWEIKERT. Tell me your thoughts on it.

Mr. JOHNS. I think we are supportive of a common securitization platform. That is through Freddie and Fannie effectively combining forces to create one entity.

The benefits of that, of course, are if you combine a Freddie and a Fannie security, you have now effectively merged two markets into one. And we all know that the larger the market is, generally, the more liquid it is, which is a positive.

Mr. SCHWEIKERT. And I know I am over time, Mr. Chairman.

But the benefits of a common securitization platform, commonality in information disclosure, commonality in products, so the ability to purchase and actually see visibility.

Mr. JOHNS. Correct. And by commonality, you create consistency automatically between the two securities that have now been merged to one.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. Thank you.

Mr. Hultgren is recognized for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you all for being here. I really do appreciate your work and your input on these important issues.

I am going to address my first question to Mr. Renna. I have a couple of questions for you, so I will kind of package them together and see if you can respond to this.

I wonder, did the regulators, as they were preparing the rules to implement Section 941, the risk retention requirements under the Dodd-Frank Act, have an opportunity to provide flexibility to the commercial real estate market, to wonder what will the effects of this rule be on single-asset loans?

If it would not undermine investor protection or civility of the market, why wouldn't they use this flexibility?

And then, if you could talk briefly about Mr. Hill's draft legislation, would that help with this?

Mr. RENNA. To your second question, yes, it absolutely would help with it.

The issue with single-asset, single-borrower, again, goes to my point that regulators did not want to get into a level of discernment in drafting the regulations to specific asset types. That was necessary in order to achieve the goal of risk retention, yet also allow the sector to be able to function efficiently.

Single-asset, single-borrower loans weren't in any realm within the problem of what happened in the downturn of packaging of bad loans that investors had no idea what was in them.

They are a single asset that has a single mortgage on it. Investors can very clearly see how to underwrite that asset. They want to be able to invest in the bonds that are produced by that.

We provided data to the regulators explaining the historical performance of this asset class and making these other arguments that the rule should not apply to it. They just did not want to get to that level of discernment.

As a result, you are now applying a cost on single-asset, single-borrower securitization that has no prudential benefit to it whatsoever. That is going to result in a tax. And you are taxing single-asset, single-borrower and you are going to reduce the capacity of it.

Mr. HULTGREN. Thank you.

Switching over to address a couple of questions to Mr. Plunkett, if I may, Mr. Plunkett, about H.R. 4096, the bill put forward by Mr. Capuano and Mr. Stivers, I wonder if you could explain what customer confusion might be caused by the name-sharing prohibition of the Volcker Rule and what impact this would have on the funds in your network?

And if you could just explain briefly why you think H.R. 4096 might be helpful in this?

Mr. PLUNKETT. Thanks very much. It is noteworthy that in certain foreign jurisdictions, the regulators actually require that the name of the manager be part of the fund because they want to make sure that investors know exactly who is managing the fund.

H.R. 4096 is simply a hyper-technical amendment to make it easier to permit greater transparency by having the name of the manager in the fund if the manager thinks that is beneficial.

Mr. HULTGREN. Okay, thank you.

I am going to switch back for my last couple of minutes here.

Actually, Mr. Carfang, if I can address some questions to you, I think, if I understand it correctly, you are visiting us from Chicago today, so I'm glad you are here and I'm glad you didn't get hit by the weather going through Chicago. Hopefully, we will be able to make it back later this week.

I know you mentioned earlier today that the municipal securities market has seen some liquidity challenges recently. What do you see as the major causes?

Mr. CARFANG. I think the money market fund regulations which are being phased in now through October are causing investors to withdraw assets.

In the tax-exempt market, for example, money market funds have to move to a fluctuating asset value and are subject to fees and gates and are limited to what the SEC defines as non-natural persons.

Most banks have to stand on their heads to figure out what a non-natural person is and reclassify accounts. They are simply not doing that and withdrawing the funds. Forty-five funds have already closed.

Mr. HULTGREN. Mr. Carfang, could you explain how the Volcker Rule impacted the cost of hedging risk and what consequences this would have for businesses and other customers of banks?

Mr. CARFANG. Okay. Well, the Volcker Rule and the prohibition for proprietary trading reduces volumes and reduces the size of dealer inventories, which increases the spreads. Those wider spreads, when a farmer is trying to hedge a product, they are paying a higher cost.

And what will happen is at the margin, some will make decisions, actually go naked and not hedge, but take the risk themselves.

When the risks are centralized through clearinghouses or within banks, they are very visible. They can be quantified, they can be managed.

When the risks are dispersed through hundreds of farms or co-ops or thousands or whatever, the risks fall in the hands of those least able to understand and to have the market access to manage them.

Mr. HULTGREN. I see my time has expired. Thank you all for being here.

Mr. Chairman, thank you for the time. I yield back.

Chairman GARRETT. Mr. Stivers is recognized for 5 minutes.

Mr. STIVERS. Thank you very much, Mr. Chairman. Thanks for holding this hearing on a lot of important proposals that are coming before this committee.

And I appreciate all of you for being here and spending some time with us.

Mr. Plunkett, I want to follow up on a question that the gentleman from Illinois just asked you about H.R. 4096, which Mr. Capuano and I are sponsoring.

Do you think this legislation is any kind of meaningful alteration of the intent of the Volcker Rule?

Mr. PLUNKETT. No, Congressman. It preserves the basic intent of the Volcker Rule provision which is really intended to keep the name of the bank itself off the name of the hedge fund.

Mr. STIVERS. And so, this proposal actually will help give investors more information, but not confusing information. Is that correct?

Mr. PLUNKETT. It will give them the name of the manager, which, in the case that the bill addresses, is totally different from the bank already.

Mr. STIVERS. Exactly. Thank you so much for that.

And Mr. Carfang, I have a question on the Volcker Rule. Do you believe the Volcker Rule is driving part of our liquidity problems that people are talking about a lot in the marketplace?

Mr. CARFANG. Absolutely. It is causing dealers to not be as active in the marketplace. Many dealers are actually now focusing on fewer markets, so you have market makers that used to be very broad, and make markets in a lot of debt securities and fixed income products, but are now specializing in just a few, which then

makes all the participants beholden to just a few market makers in every security. That is risky.

Mr. STIVERS. And what does that mean for investors and anybody who has to access the market by buying and selling securities, bonds or anything that—

Mr. CARFANG. It generally means either higher costs or lack of supply, lack of access to the market completely.

Mr. STIVERS. And candidly, it basically means both or some combination of the two.

Mr. CARFANG. Generally, it is a combination of the two.

Mr. STIVERS. There was a PWC study that talked about the regulatory impacts that were helping create this liquidity problem. Have you seen any other studies with similar conclusions?

Mr. CARFANG. The U.S. Treasury itself through its TBAC report actually talks about collateral scarcity and the fact that when you add up the collateral requirements in terms of HQLA, liquidity buffers in money market funds, capital buffers in banks, across-the-board, the sum of the requirements for high-quality liquid assets basically consumes all high-quality liquid assets in the marketplace. So you have really put a binding constraint on economic activity.

Mr. STIVERS. If you were advising the FSOC or the Office of Financial Research, do you think this is a subject they should look into?

Mr. CARFANG. Absolutely. This is one of the most important things.

Mr. JOHNS. I would just, maybe if I could add something?

Mr. STIVERS. Yes, please.

Mr. JOHNS. I don't think it is just FSOC who should be looking into this. I would encourage the regulators to do their own review. I would advise more hearings of this nature. We totally endorse that.

Mr. STIVERS. What about the OFR, which is responsible, under Dodd-Frank, the bill that you supported, to do research on systemic problems? Shouldn't they research this? It is their job to research.

Mr. JOHNS. Sure. Frankly, from the perspective of SFIG, we would encourage as many studies across-the-board as we can possibly get on this—we haven't even seen Dodd-Frank finish its implementation. We are not going to see that for another 2 or 3 years. So the most liquid market in the world right now is suffering, while in Europe, which has never been as liquid as the United States, we are seeing actions already being taken to try to make sure that they don't over-regulate.

Mr. STIVERS. Yes. And I think that this coming crisis has lots of causes, but one of them is directly at regulators and especially the Volcker Rule. So we need to make sure that we can understand the causes and the impacts on consumers, investors, and the marketplace, and what it means for volume and how some of it will move overseas.

And we also need to make sure that we address it as quickly as we can in a meaningful way and mitigate the problems created by it.

Mr. JOHNS. I completely agree.

Mr. STIVERS. Yes, thank you.

I yield back the balance of my time, Mr. Chairman.

Chairman GARRETT. Thank you.

The gentleman from California, Mr. Royce, is recognized for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Renna, when you suggest that $200 billion of commercial mortgage-backed securities in the marketplace will require refinancing, you say over the next 2 years, what would happen to borrowers if CMBS lending is insufficient to cover that need or that sum?

Mr. RENNA. Thank you, Mr. Royce. Basically, the borrowers become more in distress because they have to go to a different type of lender. The CMBS lender is a very efficient lender. It gives them best price and proceeds. It also provides them with a 10-year fixed loan that is non-recourse in nature.

If they have to go to a different lender to refinance their asset when their loan comes due, they are probably going to go to a lender that can only provide them shorter-term, perhaps a floating-rate loan, and would require recourse.

All those things mean, to cut through the technicalities, that borrowers are not going to be able to borrow as much for their asset and they are going to have to put up more equity. And if they can't do that, then they are going to be in default.

Mr. ROYCE. So what would the economic impact be, let us say for pension funds, or life insurance? When you look at constituents out there, how would that affect them?

Mr. RENNA. Sure. The performance of the bonds is what the pension funds and life insurance companies are interested in. If the underlying mortgages are not performing because when they come up to refinance they have difficult refinancing, then their investment is going to suffer as a result of that.

And going forward, when they want to go and then reinvest in those types of CMBS bonds that provide them the risk-adjusted return they are looking for, there is not going to be as much of that in the marketplace for insurance companies and pension funds to invest in to provide them with the cash flow they need to match up with their needs with respect to beneficiaries.

Mr. ROYCE. As you know, European regulators are considering a high-quality securitization framework that could differ from U.S. rules. It appears that in Europe, they recognize that the current rules under consideration in their argument may be too onerous to support a liquid ABS market.

If we don't have global convergence on these rules, what would that impact be on the United States?

I will ask Mr. Johns that question.

Mr. JOHNS. If you don't have global convergence, you have two issues. Number one, if Europe just goes its own way, then you will see European collateral gets the capital relief, and European investors get to take that capital relief. So consequently, they are incentivized to just invest in Europe while the U.S. investor base will remain permanently based in U.S. assets.

That creates, maybe not a bifurcation, but it certainly fragments a global market. And we all know markets are global.

If you see Basel/IOSCO take root, then all investors across the world, except for the United States right now, potentially could get this capital relief, meaning that they now can get a higher rate of return on capital by investing in the same product relative to what a U.S. investor might be.

That means you are going to see more non-U.S. investors investing in the U.S. economy. I don't think that is a good thing. If you expand to what happens if we see another crisis and another bailout mechanism, what we saw last time is when local governments came in and gave money to their local banks, there was a stipulation attached to a lot of that, that they could only then re-lend it within that jurisdiction.

Mr. ROYCE. The European Commission created a Better Regulations Task Force. And that includes a public call for evidence to review financial regulations and to consider ways to recalibrate rules to support market liquidity, lending, economic expansion.

Does it make sense then that we do the same?

Mr. JOHNS. It makes absolute sense. We have a lot more to lose, considering how liquid our markets are to begin with.

Mr. ROYCE. I will go back and let Mr. Renna answer that, and expound on that other question I had asked as well about the consequences.

Mr. RENNA. Yes, there definitely needs to be an alignment between the United States and Europe and how they are applying these types of standards.

And again, I think it goes to, Congressman, just the idea of uncertainty in the marketplace with respect to how regulators generally are treating the capital markets.

The capital markets are global. They are not just European or U.S., they are global, and there needs to be harmonization between the two.

Mr. ROYCE. Thank you very much, Mr. Chairman. I appreciate the time.

Chairman GARRETT. The gentleman yields back.

And I see we have been joined by a couple of other Members.

Mr. Ellison is recognized for 5 minutes.

Mr. ELLISON. Let me thank the chairman and the ranking member and all the members of the panel.

Just a few questions. Section 941 of Dodd-Frank requires that securitizers or originators retain up to 5 percent of the credit risk of asset-backed securities.

Directing my question to Mr. Stanley, could you please describe why Congress and the public determined that it was necessary to retain such risk? And what problem was Congress wanting to address by requiring skin in the game?

Mr. STANLEY. Fundamentally, what we learned during the financial crisis was that there are grave dangers in the originate-to-distribute model because the people who are structuring very complex, very opaque securities are selling them to other people who will take the losses if those securitizations fail to perform.

And we saw investors being misled about the quality of the underlying loans in the securitizations—police this market. And I think reforming the credit rating agencies is another thing we need.

But risk retention is designed to align those incentives properly between the sponsor and the investor.

Mr. ELLISON. So, there is a pending piece of legislation, H.R. 4166. It would allow a CLO manager to only retain about .004 percent or 40 basis points of the credit risk of a qualifying CLO if the CLO meets certain requirements. Is retaining only 40 basis points significant enough to ensure that the CLO manager has an economic interest in the long-term performance of a security?

Mr. STANLEY. I don't believe it is. That is $400,000 in economic risk on a $100 million deal. I don't believe that is adequate.

And we also saw that in order to qualify for that level of risk retention, there were no restrictions or rules put on the quality of the underlying loans there. You could lend to a very, very heavily leveraged company to the equivalent of subprime business lending and get that exemption.

Mr. ELLISON. So how does retaining 40 basis points, or .004 percent, slice of the credit risk compare to a CLO manager's other income?

Mr. STANLEY. Excuse me, I am not sure—

Mr. ELLISON. I guess the question is, how meaningful is it? Is it a loss that they can bear? So my question is, how does retaining a 40 basis point slice of the credit risk compare to a CLO manager's other income?

Mr. STANLEY. I think that absolutely would be a loss that they could bear. And potentially, the danger that you see is that you could profit more on misleading investors as to the quality of a hundred million dollar deal in terms of the price you would get for that than you stood to lose in terms of the risk that you had retained.

Mr. ELLISON. Thank you.

Ms. COFFEY. Congressman Ellison, may I put some math around the numbers?

Mr. ELLISON. Feel free, yes.

Ms. COFFEY. Certainly. One of the things that the Dodd-Frank Act said is credit risk retention needs to be 5 percent of the credit risk of the assets. It does not need to be 5 percent of the notional amount of the securitization; it has to be 5 percent of the credit risk.

So one of the things that has been proposed in the qualified CLO is that the CLO manager must retain 5 percent of the equity. Almost all the credit risk resides in the equity; so therefore, by holding 5 percent of the equity, the manager is holding 5 percent of the credit risk.

When you add the subordinated fees on top of that, which also invites credit risk, they hold more than 5 percent of the credit risk. That actually conforms with the Dodd-Frank Act.

Mr. ELLISON. Do you buy that, Dr. Stanley?

Mr. STANLEY. Yes. I just don't see how we can argue after the experience of the financial crisis that the only credit risk in a securitization is just in that equity slice.

When you look at this bill, the CLO is actually allowed to hold 10 percent of its assets in high-risk loans. They only have to hold—the requirement is that they hold 90 percent of their assets in sen-

ior debt. So, that could be 10 percent of their assets in high-risk business loans.

And that 10 percent itself exceeds the 8 percent equity tranche. So, I just don't really buy the argument.

Mr. ELLISON. Mr. Green, do you have any thoughts on this?

Mr. GREEN. Yes. And I would add that the performance of the higher tranches was a problem as a mark-to-market basis during the crisis. And quite frankly, you saw, which is what motivated the conflicts of interest rule by Carl Levin, and the Technology Permanent Subcommittee on Investigations highlighted very clearly, and which is somewhat presented in the movie, "The Big Short," that has not been done and completed by the Securities and Exchange Commission to date.

So there are a lot of things that need to be done, including the final implementation of risk retention, the implementation of the ban of conflicts of interest and other things.

Mr. ELLISON. I am out of time. Let me thank the panel.

Chairman GARRETT. The gentleman's time has expired.

Mr. Messer is recognized for 5 minutes.

Mr. MESSER. Thank you, Mr. Chairman.

I want to thank all of the members of the panel.

As a Member who represents 19 rural counties in southeastern and central Indiana, I frequently hear from constituents who are struggling to gain access to capital, loans, and financial products that fit their unique needs.

Many of the lenders in my district, and financial services providers, have expressed concerns to me about the overly burdensome regulations and increased compliance costs and that they are a major hindrance to their ability to serve customers in my area of the country.

And while most everyone agreed that in the wake of the 2008 financial crisis, reform in the financial service sector was necessary, this Administration's response with a cocktail of laws and regulations has, in effect, prevented healthy market competition and caused severe liquidity shortages, as we have discussed today.

I want to thank the chairman for calling this hearing to discuss the difficulties these laws and regulations have caused for commercial mortgage-backed securities and collateralized loan obligation providers.

These providers fill important market demand, especially in my district in Indiana, and all across the country.

I believe the proper role of the Federal Government should be to promote consumer choice and encourage competitive markets and provide smart regulation to protect consumers. Of course, that doesn't mean that government should try to regulate all risk out of the market.

And so, my first question is to Mr. Renna. You mentioned today in your testimony that as a result of these risk reduction policies, we should see a reduction in overall commercial lending. What effect do you think that will have in tertiary markets or, in English, smaller markets like in my district in rural Indiana? Do you think we will start to see those effects even before regulations kick in at the end of the year?

Mr. RENNA. Yes, thank you, Congressman. Those are the markets that are going to suffer first, because what CMBS achieves and the role that it fulfills in commercial real estate lending is to mostly be able to provide financing to secondary and tertiary markets, not major markets themselves.

It does this because by accessing the public capital markets, you get an efficiency of borrowing, and that passes through to borrowers who maybe don't have the most pristine credit or their assets have some issues with them.

CMBS is intended to apply to those types of properties. And if there is too much restriction on it or unnecessary restriction—we accept risk retention. It is the law until Congress changes it. We are simply trying to get the regulators to acknowledge the uniqueness of our asset class within the regulatory rules.

Mr. MESSER. And take their business elsewhere after these regulations kick in, away from commercial mortgage-backed securities.

Mr. RENNA. Everything is risk-adjusted return. It is really going to depend on the ability of the lending market to be able to put the product out there for investors. I think the investors will find that it is a solid product, but it is going to be—I think the calculus more is, what is the entire amount of financing that the lenders will be able to provide?

Mr. MESSER. Yes, okay.

Next question to Ms. Coffey. And again, I appreciate your testimony as well. You note in your testimony that more than 1,000 companies employing more than 6 million people receive financing from CLOs, securitized corporate debt, many of which, of course, do business in Indiana and in my district, and I am sure in almost every other district in the country.

Would you elaborate on the effects that rules like the Volcker Rule and others could have on U.S. businesses that rely on asset-backed security markets?

Ms. COFFEY. Sure. What I would like to do is focus on risk retention because that is very much the challenge today.

What the risk retention rule will do is it will dramatically reduce the formation of CLOs going forward. We have already seen that. Starting in the second half of 2015, investors required risk retention on CLOs or the ability to comply and issuance dropped off very dramatically.

What does this mean to companies like those in your district? This means that the $420 billion of financing that CLOs provide to companies, like those in your district, will no longer be available. What will those companies do?

They have two choices. They can find more expensive sources of financing, like hedge funds, not ideal, or they might not get the financing at all, which would impact jobs, could create downsizing, or, worst-case scenario, even bankruptcies.

Mr. MESSER. So you have sort of answered this question, but let me ask you more directly. Will these policies hurt the very people that they are designed to protect?

Ms. COFFEY. Absolutely.

Mr. MESSER. Thank you.

I have no further questions, Mr. Chairman. I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back his time.

The gentleman from Massachusetts, Mr. Capuano, is recognized for perhaps the final word.

Mr. CAPUANO. That is good; I like that.

Chairman GARRETT. I know; that is a little scary.

[laughter]

Mr. CAPUANO. I know, it is unusual. I will make it nice.

Mr. Chairman, I just came by briefly. First of all, thank you for your indulgence. I am not on this subcommittee. And thank you for the opportunity to participate for a minute.

I really just came by to say thank you to the chairman and the ranking member for putting forward what is hopefully a relatively noncontroversial bill.

I consider myself a great defender and a great supporter of Dodd-Frank and all these items that we have discussed today. I think most of my position is pretty clear.

However, I never thought that any law was 100 percent. And I think part of our responsibility is when we do something, if we find a problem with it later on, we should fix it.

I actually think H.R. 4096 is a relatively simple fix to a relatively simple problem that I don't believe at all will jeopardize anybody. And for those of you who think that it might, I would love to have a discussion with you to see. This is not the place. I actually don't like these hearings because you can't have a discussion. I would like to hear from you because that is not my intent.

My intent is simply to allow business to do something that I don't think we intended to do in the first place.

And I want to say, Mr. Chairman, that I think it is—I am not so sure how I fit into this bipartisanship. It is not comfortable for my role. I am not used to it.

But I am getting used to it. Last year, you and I cosponsored a bill, and I really expected the earth to split in half when you and I cosponsored a bill. And it didn't happen. I was a little disappointed.

Chairman GARRETT. It held together, yes.

Mr. CAPUANO. We can hope.

Chairman GARRETT. We can do it again.

Mr. CAPUANO. I hope so. And this year, again, these are small bullet shots right directly to a problem. And I wanted to, again, thank you for the opportunity to do this.

I know it is unusual, not just for me, it is also a little unusual for you. And I wanted to thank you for doing it and I look forward to working with you on this and many, many important items in the future.

Chairman GARRETT. For years to come.

And I thought you were going to be the last word on this.

Mr. CAPUANO. Barr came back, huh?

[laughter]

Chairman GARRETT. Mr. Barr has returned.

Does the gentleman yield back the remainder of his time? Thank you.

Mr. Barr is recognized for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman.

To the witnesses, thanks for your patience. I think I am at the end of the line here.

I want to focus on how the regulators' overly broad application of risk retention requirements will actually destabilize the financial system, and how my legislation, H.R. 4166, the Barr-Scott legislation, would actually enhance financial stability.

First, I would reference a letter that I wrote to the Chair of the Federal Reserve, Janet Yellen, last fall, in which I asked whether or not she would support the concept of a qualified CLO as included in our legislation.

And in part, this is what she wrote back, "The Board recognizes certain structural features of qualified CLOs may contribute to aligning the interests of CLO managers with investors with respect to quality of securitized loans in this regard. An increase in the availability of CLOs that reflect strengthened underwriting and compensation standards, among other features, could be considered a positive development in the market."

I request unanimous consent to insert this letter into the record.

Chairman GARRETT. Without objection, it is so ordered.

Mr. BARR. Thank you.

And now, I would like to turn to Ms. Coffey and examine Dr. Stanley's contention that bond issuance assured Mr. Green's arguments that this is a make-believe liquidity crisis.

This contradicts your testimony regarding the 2015 precipitous drop in CLO issuance. And I would like to give you the chance to respond to that.

Ms. COFFEY. Thank you very much, Congressman Barr.

As we saw in 2015, the beginning of the year actually went fairly well for CLO formation and, hence, financing to U.S. companies.

By the time we hit the middle of the year, most investors were saying CLO managers needed to be able to show the ability to comply with risk retention. And we saw CLO formation drop 40 percent in the first half of the year. We saw 39 issuers that issued CLOs in 2014 being unable to issue them in 2015.

Mr. BARR. Yes, and considering the fact that mortgages were at the epicenter of the crisis, and yet enjoy a qualified mortgage safe harbor, it seems to make sense that we should provide an analogous safe harbor of a qualified CLO to an asset class that, as you have testified to, performed much better during the financial crisis in over a 20-year period. Obviously, it performed well with a negligible default rate.

Let me ask you also, Ms. Coffey, to respond to, I think Dr. Stanley's concern, about covenant light loans. And what does our bill do about covenant light loans and asset quality?

Ms. COFFEY. Certainly. So first of all, one of the things I would like to say about covenant light loans is our proposal actually has a constraint on covenant light loans, limiting them to a lower amount than what we see in the market today.

Mr. BARR. So asset quality would actually be enhanced through this legislation?

Ms. COFFEY. Correct.

Mr. BARR. Now, let us turn to my colleague, Mr. Lynch's, concern, and Dr. Stanley's concern, that our bill would risk repeating the originate-to-distribute model that led to the financial crisis.

Can you respond to this particular criticism, especially with reference to the fact that CLOs are long only, match funded, meaning that they issue long-term bonds, not mark-to-market and, therefore, actually act to stabilize the market?

Ms. COFFEY. Absolutely. Two points. One, CLOs are not originate-to-distribute securitizations. Two, CLOs are completely match funded. They are buyers when other people are sellers; and thus, they act to stabilize the market. That is a very important benefit for U.S. companies.

Mr. BARR. And finally, let us talk about 2018, 2019, and 2020 and the maturity wall with CLOs. And if we don't fix this problem, what will happen to the financial stability of the corporate credit market out there, particularly when you have, as Moody's says, CLO formation shrinking and corporate refunding requirements expanding, especially through 2020 and the impact that a failure to fix this problem will have on access to credit and the cost of financing for job-producing American companies?

Ms. COFFEY. Absolutely. In 2019, 2020, there is expected to be $700 billion of refinancing needs. CLOs, as they are currently constituated, have about a hundred billion dollars in 2019, and about $20 billion of capacity in 2020. If they go away, if there is no more CLO formation, that gap is going to have to either be financed elsewhere expensively through entities like hedge funds, or companies will not get the financing they need.

Mr. BARR. And in the remaining time that we have, about 30 seconds, could you talk about the impact that diminution of the CLO market will have on job creation, and then also why a qualified CLO concept enhances the distinction between the residential mortgage-backed securities that were the cause of the financial crisis and what we are describing here in this legislation?

Ms. COFFEY. Absolutely. The qualified CLO puts six constraints on CLOs that will enhance their quality: asset quality; portfolio diversification; capital structure; alignment of interest; regulation and transparency; and disclosure. By putting that in and requiring the manager to retain 5 percent of the equity, we meet the Dodd-Frank rules and we will have a continuation of CLOs that will provide financing to U.S. companies.

Mr. BARR. Thank you for testifying.

Mr. JOHNS. And I would just add one thing, from an SFIG perspective. We have investors and issuers in our membership; about 20 percent of our 350 members are investors. This has support across-the-board here, so the balance of making sure investor and issuer interests is pretty well-established.

Mr. GREEN. And if I could add one thing, it is important to distinguish between liquidity and credit. Absolutely, we should make sure that companies have access to credit. But the most important thing to do is they have to assure that credit quality is good, that means the macro economy continues to need to grow.

Mr. BARR. I think it is an indication that we need to be focusing on what the views are of market participants, not just what the New York Fed is saying.

Thank you, I yield back.

Chairman GARRETT. And with that note that we are not going to be paying so much attention to the New York Fed going forward—

[laughter]

Let me begin by saying thank you again to the entire panel. This was a great panel from both sides of the argument here, but very in-depth, and I very much appreciate getting into the weeds with this complicated issue.

And I very much appreciate having people like Mr. Barr and Mr. Hill here who were able to dive down into it, certainly with Mr. Hill's background in this area as well.

So thank you, Mr. Hill, for your knowledge on this topic and for digging it out as well.

I think one of the takeaways today is that this was the highly rated asset-backed securities. I think it was uncontroverted, was not, vis-a-vis the other asset classes, a cause of the root problem. I think we have heard that from the very beginning to the very end.

And I think we also heard, not unanimously of course, but strongly, from the actual market participants that we are concerned about, that we should be concerned about the impact of Dodd-Frank in this area.

So with that being said, I would like to thank all the witnesses again.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And without objection, this hearing is hereby adjourned. Thank you.

[Whereupon, at 12:32 p.m., the hearing was adjourned.]

A P P E N D I X

February 24, 2016

Testimony of Anthony J. Carfang, Partner
Treasury Strategies, Inc.
February 24, 2016

U.S. House Subcommittee on Capital Markets
and Government-Sponsored Enterprises.

Good morning Chairman Garrett, Ranking Member Maloney, and members of the Committee. It is an honor to be invited to testify at today's hearing: ***The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Markets and Securitizations***. This is a timely hearing that goes to the heart of the stability of the financial system and I am pleased to be able to contribute to the discussion.

I am Anthony J. Carfang, a partner of Treasury Strategies, Inc. Treasury Strategies is a leading consultancy in the area of treasury management, payments and liquidity. Our clients include the CFOs and treasurers of large and medium-sized corporations as well as state and local governments, hospitals and universities. We also consult with the commercial banks that provide treasury and transaction services to these organizations.

I am here today on behalf of Treasury Strategies and the hundreds of businesses, state and local governments and financial institutions to whom we consult.

Overview

Let me first state that Treasury Strategies and our clients fully support well-thought-out efforts to improve economic efficiency and to reduce the likelihood of another systemic failure. We advocate pro-growth measures that stabilize and strengthen the financial system. The regulatory objectives of improving accountability and transparency, reducing systemic risk, ending "too big to fail," protecting consumers and putting an end to taxpayer-funded bailouts are laudable. We applaud you for tackling such important issues.

However, we feel strongly that several recent financial regulations such as Dodd-Frank, Basel III, Money Market Fund regulations and many more, both alone and in concert with each other, create a **climate of uncertainty** of enormous proportions. In addition, they triggered **regulatory and compliance cost burdens** that radiate through the economy. Ultimately, this has led to a **culture of indecision** that is choking the U.S. economy and paralyzing American businesses and financial companies that had nothing at all to do with the financial crisis.

It is in this context that I frame my testimony today. The climate of uncertainty and the culture of indecision brought about by these regulations are impeding normal access to capital. Legislative proposals such as H.R.4096, the "Investor Clarity and Bank Parity Act," H.R.4166, the "Expanding Proven Financing for American Employers Act," the CMBS Risk Retention Draft (and many more) are required to restore the efficient flow of capital that makes America's capital markets the broadest and

deepest in the world. These are small but important steps to ensure that Main Street businesses, municipalities and banks have access to the growth capital that they and their customers require.

Adverse Impact of Post-Crisis Regulations

The rollout of Dodd-Frank and its Volcker Rule, Basel III, and Money Fund Regulations is still ongoing. Most are in the midst of a phased implementation, so the full impacts and chain reactions of unintended consequences are only beginning to be felt. Yet we are already seeing a contraction in the availability of financial services and transaction services. Below is a partial listing of some of the dislocations we at Treasury Strategies are already seeing; we learn of new restrictions and prohibitions almost weekly:

- **There are 1,460 fewer banks today** than at the time of the passage of Dodd-Frank. The number of U.S. banks and savings institutions has decreased from 7,821 on 6/30/2010 to 6,358 on 6/30/2015. The loss of nearly 1,460 commercial banks over five years has numerous consequences, some of which are less consumer and business choice, higher borrowing costs and less access to credit.

- In the ten years prior to the 2008 crisis, the FDIC averaged 157 new bank charters per year. Going back to the earliest FDIC statistics in 1934, there was never a year in which the FDIC chartered fewer than 15 new commercial banks. That is, until 2010, when it chartered only five. **Only two new banks have been chartered in the five years**

since 2011. Again, this dearth of new banks stifles innovation as well as reduces choice and competition for businesses and consumers.

- In the two years since the money market mutual fund regulations were announced, **27 tax-exempt money funds have closed**[1] and many more are expected to follow before the full regulatory implementation in October 2016. These funds are the lifeblood of efficient, short-term financing for state and local governments, hospitals and universities. Treasury Strategies estimates that $10 billion has already left the market, and the pace has accelerated in December and January as we approach the October effective date.

- In the two years since the money market mutual fund regulations were announced, **56 prime money funds with $264 billion[2] have converted to government money funds**. This takes capital away from private sector businesses and shifts it to the federal government, further driving up costs for businesses.

- Basel III is changing the profit and balance sheet dynamics of banks, essentially penalizing deposits. To comply, some banks must **discourage deposits with higher fees or lower interest**.

- Basel III is also requiring banks to hold a much higher proportion of government securities instead of traditional business loans. Many are **restricting credit to all but the highest quality borrowers**. As a

[1] www.cranedata.com
[2] www.cranedata.com

result, many companies and municipalities are faced with higher borrowing costs or unable to borrow at all. The really perverse consequence is that these borrowers go "off the grid" entirely and resort to unregulated or underground lenders.

- Many banks, to comply with Basel III's liquidity plank, are **cutting back on issuing lines of credit** to their customers. Since most companies rely on these backup lines for emergency liquidity, their alternative is simply to hold more idle cash on their balance sheet. That sidelines productive capital and also impairs economic efficiency.

- The combination of the Volcker Rule and increased capital requirements results in financial institutions scaling back their market making activities. This results in wider bid/ask spreads and ultimately less liquidity in the market. There have been sporadic **liquidity black holes in which markets completely freeze up** or prices gyrate wildly such as the U.S. Treasury flash crash. A study by Deutsche Bank estimates that dealers have cut their inventories by as much as 80%.

- The **higher costs of hedging risk** because of the Volcker Rule and other Dodd-Frank provisions are leading some businesses to not hedge at all. That means that some businesses no longer have protection from cost gyrations in their supply chain and actually **take on more risk.** All we've done is shifted risk and made it less visible.

- Virtually all of the regulations discussed in this testimony require financial institutions and businesses to hold more government

> securities. These requirements hide under names like "collateral," "high quality liquid assets," "liquidity buffers," "segregated funds," "risk retention" and other euphemisms. The net effect, however, is to **remove productive capital out of the real economy and leave it stranded in government securities**. A recent Treasury Strategies report actually warns of a pending collateral shortage that could seriously exacerbate risk in times of financial stress.

As I mentioned, this list grows with each passing week.

How High are the Stakes?

Businesses operating in the U.S. are the most capital-efficient and productive in the world. Highly liquid means of raising capital allow treasurers to keep less cash on hand and use a just-in-time financing system that allows companies to **meet payroll**, **pay bills** and **raise the capital** needed to **grow** and **create jobs**.

Unfortunately, because of the climate of uncertainty created by the poor rollout of Dodd-Frank, the draconian demands of Basel III and ill-formed money market fund regulations, capital efficiency in the U.S. has declined, as evidenced by increased corporate cash buffers. The sad trend line is that corporate cash has swelled from 9% of U.S. GDP to nearly 12% of GDP, idling hundreds of billions in cash. **Companies are keeping more precautionary cash to deal with the regulatory uncertainty**.

Consider the following Treasury Strategies analysis: companies doing business in the U.S. operate with approximately $2 trillion of cash reserves, with a like amount held by smaller businesses. The current climate of uncertainty resulting from this legislation is pushing U.S. cash steadily upward. Stated differently, CFOs and treasurers are setting aside and idling an additional $1 trillion of cash. To put that in perspective, that $1 trillion is:

- Greater than the entire TARP program
- More than the stimulus program
- Greater than the Federal Reserve's quantitative easing program

To raise this extra $1 trillion cash buffer, companies are postponing expansion and deferring capital investment, downsizing and laying off workers, and reducing inventories. Obviously, the economic consequences are huge.

The Nature of Financial Risk

I would like to add a statement about managing financial risk. A common understanding among our clients is that, like energy, risk can neither be created nor destroyed but only transformed. So when you consider ways to reduce financial system risk, do not be tricked into thinking that risk disappears. It simply moves elsewhere. That's why the risk retention issue is a red herring. It's like buying car insurance. You're risk of an accident does not go down. Rather, the financial consequences shift elsewhere.

To truly minimize the probability of future financial crises, we must understand how this risk transforms and where it will show up next. Risk is managed most efficiently when it is transparent, properly understood and the market responds with robust, efficient and liquid solutions.

Summary

The ambiguity surrounding the rollout of multiple financial regulations is already having a chilling effect on precisely those financial services that account for U.S. competitiveness, capital efficiency and financial stability. This is an issue for U.S. businesses and municipalities, large and small.

Some of the unintended consequences, in addition to a general slowdown in economic activity, include:

- Impaired market liquidity and reduced access to credit
- Higher costs and less certainty for borrowers
- Restricted trading in proper and allowable businesses
- Competitive disadvantage for U.S. businesses and financial institutions
- Increased compliance costs for non-financial businesses
- Higher bank fees for consumers and businesses
- Less access to capital for small businesses and start-ups
- Shifting of risks to other sectors of the economy
- Capital flows into offshore markets

Because of the protracted rule-writing process, many rules have yet to be written. Of the rules already promulgated, most have a phased implementation. Thus, the true costs of the rules have yet to be seen.

Well-thought-out efforts to mitigate the adverse consequences of these regulations and restore the smooth flow of capital in the U.S. economy are essential. H.R.4096, H.R.4166 and the CMBS Risk Retention Draft are solid steps in that direction.

Conclusion

I appreciate the opportunity to appear today on behalf of Treasury Strategies and our hundreds of business, municipal and financial services clients.

We strongly encourage Congress to put America's businesses back on the right track by allowing/restoring the free flow of capital. That means instituting protection for those businesses and financial institutions that had nothing to do with causing the crisis.

I am delighted to discuss these issues further and answer any questions.

Respectfully,

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Testimony of Meredith Coffey

Executive Vice President of the Loan Syndications and Trading Association

House Subcommittee on Capital Markets and Government Sponsored Entities Hearing on

The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations

February 24, 2016

Good afternoon Chairman Garrett, Ranking Member Maloney and members of the Committee. My name is Meredith Coffey, and I am the Executive Vice President in charge of research and analysis at the Loan Syndications and Trading Association, or LSTA.[1] The LSTA is an association that represents the interests of all participants in the nearly $4 trillion corporate loan market. Importantly, the LSTA does not represent the securitization market or the market for Collateralized Loan Obligations (or "CLOs"). Instead, the LSTA represents the corporate loan market – and our concern is how certain regulations could severely diminish securitization (particularly CLOs) and how this could markedly reduce U.S. companies' access to the loans they need to expand, build factories, build cellular networks and engage in M&A as they grow and create jobs. We are grateful to be here today to testify on how important securitization is to lending and to U.S. companies, and how some regulations have the potential to decimate this important market.

My testimony will begin with an introduction to the U.S. corporate loan market, will then describe CLOs and address how the risk retention regulations under Dodd-Frank could very adversely affect this important source of financing for U.S. companies. Finally, I would like to discuss the "Qualified CLO," which is a commonsense solution that would both meet the letter and the spirit of the Dodd-Frank Act and would avoid a material disruption of the CLO and corporate loan markets.

[1] The LSTA, founded in 1995, is the trade association for the syndicated corporate loan market and is dedicated to advancing the interests of the market as a whole. The LSTA engages in a wide variety of activities intended to foster the development of policies and market practices designed to promote a liquid and transparent marketplace. More information about the LSTA is available at www.lsta.org.

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The U.S. Corporate Loan Market

According to the Shared National Credit ("SNC") Review, which is run jointly by the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC"), banks and non-bank lenders provide $3.9 trillion in syndicated loan and loan commitments to companies. The 2015 SNC Review indicated that, based on their survey results, U.S. banks held $1.49 trillion of these commitments, foreign banks held $1.14 trillion, while non-banks (like CLOs, finance companies, mutual funds and others) provided over $760 billion in credit.[2] Some of the companies that use syndicated loans are blue chip investment grade companies like IBM, UPS, McDonalds, Wal-Mart, John Deere and Microsoft. Banks are the largest providers of lines of credit to these large investment grade companies.

But most companies are not large investment grade companies like Wal-Mart or Microsoft. In fact, the vast majority of companies in America are "non-investment grade" or rated below BBB- by S&P or Baa3 by Moody's. In 2014, Moody's rated 2,000 large US companies; over 70% of them were "non-investment grade." And there is nothing wrong with being "non-investment grade." Indeed, many of these companies are very familiar and reliable names. For instance, non-investment grade borrowers include communications companies like Cablevision, Charter Communications and Univision, healthcare companies like Community Health and HCA, airlines like Delta and American, diverse food related companies such as Dole Foods, Albertsons and Aramark, many of America's fast food chains including Wendy's, Burger King and Dunkin' Donuts – as well as turnaround situations like Dell Corp. All told, it is estimated that such loans provide financing for more than 5,000 companies.[3] Without such loans, these businesses would have to turn to more expensive financiers like hedge funds or simply be unable to access credit at all.

These companies have been fortunate in recent years; accommodative monetary policy has made credit easily available, and this credit availability has supported what has been, admittedly, a

[2] *Shared National Credits Program, 2015 Review, available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090924a1.pdf.
[3] ThomsonReuters LPC DealScan database.

tepid recovery. However, the credit environment may be beginning to change. According to the Federal Reserve's Senior Loan Officer Survey, banks have tightened credit availability in two back-to-back quarters; this is first time that has happened since the Financial Crisis. Yet, while banks may be tightening credit, borrowers' needs for credit may be increasing. On February 16, 2016, Moody's published a report noting that U.S. non-investment grade companies will have a record amount of debt coming due through 2020; this debt will need to be refinanced or the companies could face a credit crunch.[4] This development has not gone unnoticed at the Federal Reserve. Last week, Bloomberg ran an article called "Fed Frets Corporate Credit Crunch Will Crimp Economic Growth"[5] that quoted the concerns of both Federal Reserve Chairwoman Janet Yellen and Boston Federal Reserve President Eric Rosengren in this regard.[6]

In such an environment, it is unwise to materially diminish a safe and proven source of financing to U.S. companies. Unfortunately, that is exactly what the risk retention rules will do.

CLOs and the Loan Market

To understand the impact of risk retention across America, it is important to understand what CLOs are – and how important they are to US companies. Open market CLOs are a steady and proven source of financing to many industries and in many states. According to ThomsonReuters, the three top industry holdings in CLOs are Technology (10%), Healthcare (9.2%) and Retail & Supermarkets (8.1%). Of note, Oil & Gas is the 17th largest industry in CLOs, comprising just 2.4% of the overall CLO universe's industry position.

So who are these companies? As of January 2016, CLOs provided more than $420 billion in financing[7] to U.S. non-investment grade companies like Del Monte, Chrysler and United

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[5] Available at http://www.bloomberg.com/news/articles/2016-02-17/fed-frets-corporate-credit-crunch-will-crimp-economic-growth.

[7] *Thomson Reuters LPC Leveraged Loan Monthly*, January 2016, at slide 36.

Continental Airlines. All told, according to ThomsonReuters and loansmeanbusiness.com, more than 1,200 companies – employing more than six million people –receive financing from CLOs.[8]

But what exactly are CLOs and – and are they something to be worried about? Despite their unfortunate acryonym, the reality is that CLOs are straight-forward, "long-only" investment funds that invest in bank loans to U.S. companies. They are similar to mutual funds where an investment manager selects pieces of individual corporate loans to purchase and actively manages that portfolio of loans.[9] However, CLOs are match-funded, which means they issue long-term liabilities (bonds) and use the proceeds to invest in loans to US companies. Because they are match-funded, there is *not* a possibility of a run on a CLO[10] – and thus they actually act to stabilize the markets they invest in. In other words, when other investors have to sell, CLOs often stand ready to buy.

In addition, being long-only investments, CLOs are not complicated derivatives where some people have a stake in a portfolio's success while others have a stake in its failure. Nor are they "originate-to-distribute" structures that make loans simply to collect a fee, then sell them off and forget about them. At bottom, a CLO is simply an actively-managed investment fund that uses securitization technology to provide its investors exactly the risk and return they are looking for.[11]

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[8] www.loansmeanbusiness.com/positiveimpact

[9] These corporate loans are usually quite large – $20 million to more than $1 billion – and pieces of these loans are syndicated to many different investors, including CLOs. A CLO would typically purchase a $1-10 million piece of a loan.

[10] In a speech in February 2013, Federal Reserve Board Governor Jeremy Stein noted that "CLO equity does not represent a form of demandable short-term financing and hence does not have the potential to contribute to fire-sale dynamics in the same way as, say, repo financing." *Overheating in Credit: Origins, Measurement and Policy Responses*. February 7, 2013.

[11] The terms "CLO" and "open market CLO" are used interchangeably in this testimony. Both terms include CLOs that are actively managed, as described above, but do not include synthetic CLOs or "balance sheet CLOs." A "balance sheet CLO" means a CLO whose assets consist predominantly of loans originated and transferred to the CLO by one or more of its affiliates other than in (i) open market transactions or (ii) from another open market CLO, and the assets and liabilities of such CLO are, immediately after issuance of its asset-backed securities in a securitization transaction, included under generally accepted accounting principles in the consolidated balance sheet of one or more of its affiliates.

While CLOs are proven investment products that have historically performed very well, they often are mistaken for collateralized debt obligations, or CDOs. In fact, they are quite different. Critically, the collateral underlying a CLO is very different. CLOs invest in senior secured syndicated loans to U.S. companies, both large and iconic and small and growing. The characteristics, credit risk and performance of each of these loans are very transparent to the CLO manager and its investors. There is an active syndication and trading market for loans – in fact, more than $590 billion of U.S. syndicated loans traded in the secondary market in 2015.[12] Each loan is typically individually rated by a third party rating agency and there are two major pricing services that provide daily prices on these loans. Moreover, the typical CLO portfolio has only 100-150 companies in it; thus the manager tracks these individual loans easily – and can decide to sell a loan if it is underperforming. In addition, CLOs are diversified by industry, with no industry typically accounting for more than 15% of the portfolio. Finally, CLO investors receive a wealth of information regarding the CLO and the underlying assets on a regular basis. Every month, investors receive a trustee report that details the CLO's loan assets and, for each asset, reports its interest rate and maturity date. In addition, investors receive a report on the portfolio itself, how much each asset comprises of the portfolio and how the CLO is performing relative to its overcollateralization and interest coverage tests. Finally, the CLO investors receive a report on all purchases, repayments and sales during the month, as well as the identity of any defaulted loans.

Another critical difference between CLOs and CDOs is performance. In a report released in June 2015, Moody's Investors Service calculated the 10-year cumulative impairment rates from 1993-2014 for many securitization classes, including global CLOs and CDOs. The 10-year cumulative impairment rate for global CLOs was **1.52%,** while the same figure for CDOs was **44.47%.**[13] Importantly, no Aaa or Aa rated CLO tranches had *any* impairments. In contrast the Aaa impairment rate on CDOs was 35.89%; it was 45.35% of Aa rated CDO notes.[14]

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[12] LSTA *Week in Review* (Jan. 22, 2016).

[13] It is important to differentiate between Mark-to-Market price declines on CLO notes and actual losses. As an example, in early 2009, CLO Aa-rated note prices had dropped to less than 20 cents on the dollar on average.

Why did CLO notes perform so well? This performance was due to the unique characteristics described above (asset performance, diversification and disclosure) as well as structural protections in CLOs and an alignment of interest that already exists between the CLO manager and its investors.

But regardless of the critical role CLOs play in the provision of credit to U.S. companies and notwithstanding their stellar performance, CLOs are currently set to be swept up in – and materially harmed by – the risk retention rules. Risk retention will be particularly harmful because CLOs do not fit the profile of securitizations that fit easily into those rules. CLO managers are investment advisors who are in the business of managing investments for others. Like many investment advisors, firms that manage CLOs are not heavily capitalized like banks, nor do most managers have access to capital necessary to purchase 5% of the face value of the CLOs they manage as fiduciaries to their investors.

Risk Retention

In December 2014, the agencies released their risk retention rules for all types of securitizations. These rules go effective for CLOs in December 2016. The truth is, the way the rules are written, they would significantly damage the CLO market – and, by extension, make credit more expensive, or unavailable, to the borrowers that rely upon them. In fact, even though the risk retention rules are not yet effective for CLOs, they already have impacted both the volume of CLOs being done and the types of managers that can issue CLOs.

In 2014, U.S. CLO formation totaled $124 billion, and CLOs were not being structured to be risk retention compliant as the rule was not finalized and the implementation date would still be two years in the future. In contrast, by mid-2015, investors were asking managers to either make their new CLOs risk retention compliant or show investors that the managers had a detailed and viable plan to become risk retention compliant. Due both to this shift in investor requirements and a

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However, an investor that did not sell would have been repaid in full. As noted above, not one Aa rated note ever suffered any impairment.

[14] Moody's Investors Service, Special Comment: Default and Loss Rates of Structured Finance Securities: 1993-2014. June 1, 2015, pp. 52-53.

softening market,[15] CLO issuance declined markedly. CLO issuance dropped 20% from 2014 levels, totaling $98 billion for full-year 2015. Moreover, CLO formation was $38 billion in the second half of 2015 (when investors began requiring risk retention or, at least, detailed risk retention plans), down 37% from first half of the year. Bear in mind that this drop in CLO formation also means that U.S. companies began to struggle when they looked to receive new or replacement financing.

However, the decline in total volume of CLOs being formed (and loans to companies being financed) is not the only impact of risk retention. Another unintended consequence of the risk retention rule is that it is effectively picking winners and losers among CLO managers. Large managers that have the capital to retain risk can continue in the market while smaller firms that do not have the capital cushion are struggling to meet the rule.

It is worth noting that there were 30 CLO managers that issued CLOs in 2014 that *did not* do so in 2015. As expected, the "drop outs" were disproportionately smaller managers. The managers that withdrew from the market last year had an average of $1.2 billion of CLOs under management in fewer than three CLOs. This is significant because these managers were *less than one-quarter the size* of 2015's leading CLO managers.[16] So, not only is risk retention already reducing CLO formation, but it also is squeezing out smaller managers.[17]

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[15] The credit markets also were softening in part as the Federal Reserve looked to begin raising interest rates.

[16] The top 25 managers last year's ThomsonReuters LPC league CLO tables had, on average, more than $7 billion of CLOs under management in more than 12 CLOs.

[17] As a starting point to understand why risk retention is particularly challenging for these open market CLO managers, it is helpful to review the language of Section 941 of the Dodd-Frank Act. Section 941 of Dodd-Frank sought to use risk retention to align the incentives of "securitizers" with those of their investors. The very language of Section 941 suggests that it was intended to mitigate moral hazard in "originate-to-distribute" securitizations. Section 941 says that the securitizer – that entity that "initiates or originates an ABS by ***selling or transferring assets***, directly or indirectly, to the Issuer" – must ***retain 5% of the credit risk*** of the assets. The concept here is that a securitizer has a portfolio of assets on its balance sheet and, instead of selling 100% of the credit risk of the assets, it can only sell 95% - and must retain 5%.
While requiring the alignment of the interest of a "securitizer" in an originate-to-distribute securitization with its investors is understandable, the application of risk retention to open market CLOs as proposed is very challenging. Actively-managed CLOs do not have a securitizer as defined in Dodd-Frank. There is no entity that initiates or originates a securitization by selling or transferring assets. Instead, a CLO is an investment fund; a CLO manager is hired to *purchase assets* from a number of banks or in the secondary market on an arm's length basis and actively

Unlike banks, most CLO managers are thinly capitalized asset managers. As currently structured, few have the balance sheet or the funds to purchase $25 million of CLO notes for every new $500 million CLO they do. CLO management firms typically earn around 0.35%- 0.4% management fee on the CLOs they manage. This means that a CLO management firm would earn approximately $1.5-2 million per $500 million CLO per year. (Bear in mind this is *revenue*, not profit. A very substantial amount of this goes to paying the firm's expenses and would not be available for purchasing and retaining notes.) That $1.5-2 million in annual revenue (again, not profit) is less than one-tenth the amount of money that CLO managers would need to find simply in order to be allowed to run their business[18] – a business that they have been running successfully with infinitesimal losses to note holders for over 20 years.[19]

In a nutshell, the risk retention rules are already impacting – and reducing – the CLO market. This is particularly unfortunate because CLOs have a strong, proven track record, they currently provide almost one-half trillion dollars to US companies – and their curtailment would come

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manage the portfolio during a multi-year reinvestment period. Thus, the Dodd-Frank definition of securitizer simply does not correspond to open market CLOs. Ultimately, with no "securitizer" that matches the statute, the agencies decided to classify the CLO manager as the "sponsor" as it is the entity that ***selects assets for purchase***, and then manages the portfolio going forward. Because the agencies tagged the manager, the manager would need to purchase and hold 5% of the notional value – or $25 million of notes of any new $500 million CLO that is done. This is true whether the manager would retain in a vertical pro rata strip (in other words, 5% of each of the CLO's liabilities), a horizontal first loss strip (in other words, equity equivalent to 5% of the full CLO value) and some combination of vertical and horizontal retention.

There are three problems with the Agencies' proposed solution: First, it simply doesn't fit the plain language definition of securitizer in Section 941 of Dodd-Frank to tag the *buyer* of assets as the securitizer, rather than the *originating seller*. Second, instead of conforming to the language of the Dodd-Frank Act, which required the securitizer to retain 5% of the *credit risk*, the agencies instead required the securitizers to retain 5% of the *full amount* of any securitization. The reality is that the credit risk is concentrated in the first loss position – indeed, that is why it is called the first loss position – so holding equity equivalent to 5% of the full securitization is far more than 5% of the credit risk. Third, as a practical economic matter, it is challenging for open market CLO managers to purchase and retain 5% of the notes of the CLOs they manage. It is simply too much money. While the LSTA and CLO market participants worked diligently to come to a consensual solution with the agencies, the final rule is so destructive to smaller managers that the LSTA was, regretfully, required to bring a case on behalf of CLO managers.

[18] Requiring a CLO manager to purchase and retain 5% of every new CLO is akin to requiring a mutual fund manager to buy $5 of Apple stock for every $100 of Apple stock it buys, as a fiduciary, for the benefit of its investors. The mutual fund manager would quickly run out of money and would no longer be able to offer mutual funds to its investors. The same is true with CLO managers.

[19] There are investors who are developing "risk retention" funds, but there are considerable logistical, regulatory and tax hurdles to setting up many of these funds.

exactly when the regulators are beginning to be concerned about credit availability. Indeed, as Moody's observes, new CLO formation will be "shrinking as corporate refunding needs increase through 2020."[20]

Moreover, there is no need for the CLO market to be so diminished. There is a solution that matches the policy objectives of the Section 941 of the Dodd-Frank Act. This solution has received bipartisan support in Congress[21] and the Federal Reserve Board indeed acknowledged that the solution had features that could align interests of managers and investors. This solution would require managers to hold 5% of the *credit risk* of the assets (rather than their fair value) *and* it would require CLOs to meet a series of best practices. This is, of course, the "Qualified CLO."

Proposed Solution for Risk Retention and CLOs

The LSTA strongly supports H.R. 4166, the Expanding Proven Financing for American Employers Act of 2015, that was co-sponsored by Representatives Barr and Scott, which would ensure that CLOs could continue to provide essential financing for American businesses while at the same time requiring that CLOs are structured in a manner to minimize risk. The bill would do this by creating a "Qualified CLO" that would be subject to special risk retention requirements. The Qualified CLO is structured to meet both the words and policy objectives of the Dodd-Frank Act. First, the CLO manager would purchase equity and would retain more than 5% of the credit risk of the assets[22] - as Section 941 requires the securitizer to do.[23] Second, ***in addition to*** retaining 5% of the credit risk, the Qualified CLO would ***also*** require the CLO

[20] Moody's Investors Service, "Companies Face Record Maturities; New Issuance Wave Likely in 2017"; February 16, 2016, pp 5-8.
[21] July 31, 2014 letter to the Honorable Janet Yellen, the Honorable Martin J. Gruenberg, the Honorable Mary Jo White and the Honorable Thomas J Curry, signed by 17 members of the House of Representatives.
[22] *See* Letter from Professor Christine Ivashina to Directors, Commissioners, and Staff Members of Financial Regulator Agencies re: Notice of Proposed Rulemaking, Credit Risk Retention (Apr. 1, 2013), at Appendix A to LSTA Comment Letter on Risk Retention (Apr. 1, 2013) ("April Risk Retention Letter"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=16434. The manager would retain 5% of the credit risk both by buying 5% of the equity – where the vast majority of the risk resides – as well as retaining credit risk through a deeply subordinated and deferred compensation structure.
[23] The LSTA does not concede that the CLO manager is the securitizer; rather we have simply attempted to work with regulators and lawmakers toward a solution that works both for them and for the CLO market.

manager to meet or exceed best practices in six specific areas. (In contrast, Section 941 does not require securitizers to meet any standards in addition to retaining risk.)

Essentially, the Qualified CLO creates six overlapping restrictions that meet a number of the agencies' objectives: It supports strong underwriting, it facilitates a continuity of credit, it ensures the alignment of interests of the managers and investors, it limits disruption in the market, and it protects investors. In effect, for a CLO to become a Qualified CLO, its governing documents would have to include requirements and restrictions around (1) asset quality; (2) portfolio composition; (3) structural features; (4) alignment of the interests of the CLO manager and investors in the CLO's securities; (5) transparency and disclosure; and (6) regulatory oversight. If the CLO meets all these criteria, which are detailed below, it may meet the risk retention rules by purchasing and retaining 5% of the equity.

Asset Quality: To ensure appropriate asset quality, at least 90% of the Qualified CLO's assets must be cash and senior secured loans to companies; it cannot purchase ABS interests, derivatives, loans in default, margin stock, or equity convertible notes; loans must be held by three or more investors or lenders unaffiliated with the CLO manager; and no more than 60% can be loans that rely on incurrence covenants (as opposed to maintenance covenants). In effect, the asset quality tests require the CLO to purchase higher quality assets[24] (loans) that have a lower expected loss.

Portfolio composition: The next layer of protection comes from the composition of the portfolio. Not only must the CLO purchase higher quality non-investment grade loans, but it must do so in a diversified manner. To ensure this objective, no more than 3.5% of its assets can be invested in loans to any single company and no more than 15% can be invested in loans to any one industry. With robust diversification, the whole portfolio should be stronger than the sum of its assets.

[24] The LSTA working group considered using a ratings criteria in determining "higher quality assets." However, the Dodd-Frank Act prohibits the agencies from using NRSRO ratings in their regulations, and thus we were unable to utilize a ratings based criteria.

Structural protections: The next layer of protection comes from the CLO structure itself. In order to differentiate Qualified CLOs from CDOs and to provide additional protection for the debt tranches, the Qualified CLO must have equity of at least 8% of the face value of the CLO assets. To add further creditor protections for the debt tranches, the Qualified CLO must be subject to interest coverage and overcollateralization tests that divert cash to pay down the notes if the portfolio underperforms.

Alignment of interests: Next, the Qualified CLO ensures the alignment of interests between the manager and its investors. First, it must be an open market CLO, not a balance sheet CLO. Next, the equity investors must have the ability to remove the manager for cause. In addition, the majority of the managers' fees must be subordinated to the rated CLO notes. Moreover, the manager must purchase and retain 5% of the CLO equity. These protections – the ability to fire the manager, subordinating most of the income of the manager, requiring funded retention that is not paid out upon closing – align the interests of the manager and investor.

Transparency and disclosure: The next protection in the Qualified CLO ensures that the investor has enough information to make an informed judgment about the CLO. To be a Qualified CLO, the manager must provide a monthly report that provides significant information on the assets (obligor name, CUSIP, interest rate, maturity date, type of asset and market price where available) and on the portfolio (the aggregate balance, the adjusted collateral principal amount, and the percentage of adjusted collateral represented by each name). In addition, the report must detail each Overcollateralization and Interest Coverage test and their status, all purchases, repayments and sales, as well as the identity of each defaulted asset. With all this information, the QCLO is extraordinarily transparent, unlike some of the securitizations that played a material role in the financial crisis.

Regulation: The final protection is built around regulation: The Qualified CLO manager must be a registered investment advisor, regulated by the SEC, with all the responsibilities – not least the fiduciary responsibilities – that go along with this.

With these six overlapping protections, a Qualified CLO will have a sound structure, will invest in higher quality non-investment grade loans in a diversified manner, will ensure alignment of interests between the CLO manager and investor, will ensure that the investors are sophisticated and further ensure that these sophisticated investors receive all the information they need to make informed judgments. Furthermore, it will offer all these benefits while limiting the disruption that the current risk retention rule would impose on the CLO and financing markets. Thus, the Qualified CLO approach would accomplish precisely the objectives of Section 941, related to ensuring prudent asset selection and underwriting, protecting investors, ensuring access to and competition in the provision of capital, and achieving related public interest benefits.

It is, in effect, Dodd-Frank *plus* best practices.

Conclusion

Despite an unfortunate acronym, CLOs have been a stable, safe and proven source of financing for U.S. companies for 20 years. CLOs survived the worst financial crisis since the Great Depression with extremely low default and loss rates. Moreover, they continue to provide over $400 billion in financing to U.S. companies. Unfortunately, risk retention has the potential to decimate this important market. This diminution of the CLO market will either reduce financing for companies or raise their financing costs. Fortunately, the Qualified CLO is a commonsense solution that would allow risk retention to meet the letter and spirit of the Dodd-Frank Act, while still permitting CLOs to function and provide financing to the 1,200 American companies that rely upon them.

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The Fixed Income Market and Securitizations after Dodd-Frank Act and Basel III: Serving the Real Economy and Promoting Financial Stability

Testimony before the U.S. House of Representatives
Subcommittee on Capital Markets and Government-Sponsored Enterprises

Andy Green
Managing Director of Economic Policy
Center for American Progress

Wednesday, February 24, 2016

Thank you Chairman Garrett and Ranking Member Maloney for the opportunity to testify on this important topic. I am the Managing Director of Economic Policy at the Center for American Progress, where I help lead our research on financial markets. Today, I aim to discuss (1) quantitative and qualitative evidence regarding how fixed income markets are performing and (2) offer some constructive suggestions on how you might wish to move forward with respect to them.

Fixed Income Markets are Better Thanks to Dodd-Frank and Basel III

The Data Overwhelming Demonstrates That Past Forecasts of Catastrophe Were Simply Wrong

First, I want to firmly rebut the claims that there is a so-called "liquidity crisis," or even a risk of one, caused by new and burdensome regulations. It simply is not true. The arguments have gone as follows: new Basel III capital charges and the Volcker Rule's limits on taking and holding positions will make dealer banks unable to take the inventories that markets need to remain liquid. Clients will not be able to sell, spreads will rise, and the costs of financing will rise to corporations and the real economy.[1]

[1] An industry-funded study on the Volcker Rule's impact on liquidity forecast that the Volcker Rule would devastate liquidity. Amongst several methodological errors, assumed its conclusion by taking 2007 and 2008 market conditions as the basis behind certain key calculations. It turned out to be entirely wrong. See Simon Johnson,

Just as Paul Volcker and others indicated early on, *the reality is almost entirely the opposite*.[2] Don't just take my word for it. The researchers and leadership of the Federal Reserve Bank of New York, FINRA (the securities market self-regulatory organization), and a range of independent researchers have all concluded that while there are changes in certain characteristics of the market, most measurements of liquidity today are as good, or *better*, than pre-crisis levels.[3]

First, the primary functioning of the bond markets – the placement of debt issued by the real economy – has performed spectacularly. Corporate bond issuance is robust and borrowing costs are near historic lows.[4] The dollar volume of corporate bond issuances in 2015 was a record $1.5 trillion, compared to around $750 billion in 2005.[5] The number of unique issuances has grown consistently and is higher than prior to the crisis.[6] (See figure below.)

"Should We Trust Paid Experts on the Volcker Rule?" Economix, *N.Y. Times*, Jan. 19, 2012, http://economix.blogs.nytimes.com/2012/01/19/should-we-trust-paid-experts-on-the-volcker-rule/?_r=0.

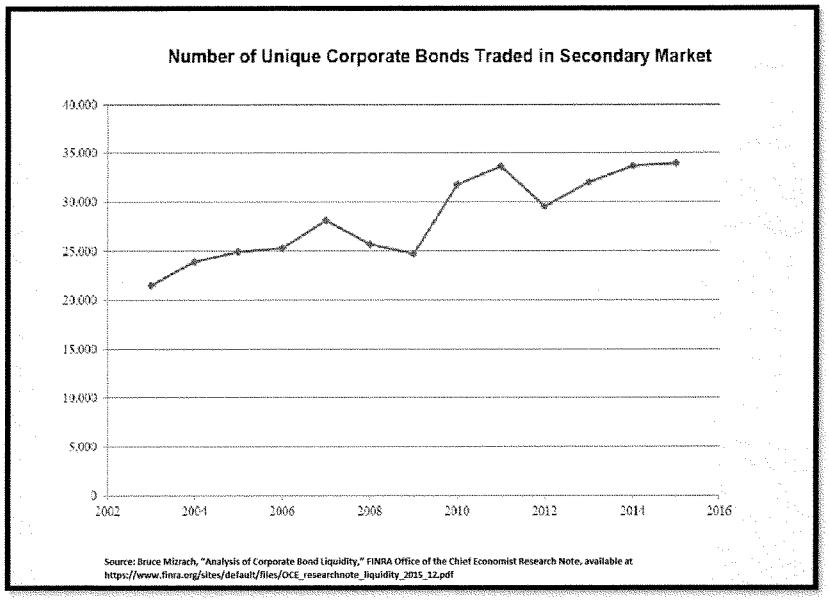
[2] Yalman Onaran and Dakin Campbell, Did Bank Rules Kill Liquidity? Volcker, Frank Respond, Oct. 20, 2014, http://www.bloomberg.com/news/articles/2014-10-20/did-bank-rules-kill-liquidity-volcker-frank-respond.

[3] Tobias Adrian, Michael Fleming, Or Shachar, and Erik Vogt, "Has U.S. Corporate Bond Market Liquidity Deteriorated?," *Liberty Street Economics*, Oct. 5, 2015, http://libertystreeteconomics.newyorkfed.org/2015/10/has-us-corporate-bond-market-liquidity-deteriorated.html#.Vsn6hOZSFdc; Bruce Mizrach, *Analysis of Corporate Bond Liquidity*, FINRA, Dec. 10, 2015, https://www.finra.org/sites/default/files/OCE_researchnote_liquidity_2015_12.pdf, see also http://www.finra.org/newsroom/2015/corporate-bond-liquidity-healthy-most-measures-finra-research; Dudley, supra; Staff Q4 2015 report on corporate bond market liquidity, provided to the Subcommittee by the staff of the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission; Francesco Trebbi and Kairong Xiao, "Regulation and Market Liquidity," Dec. 23, 2015. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2687465.

[4] See, e.g., Cordell Eddings, "Corporate Bond Sales Surge Above $23 Billion as Apple Sells Debt," *Bloomberg News*, Feb. 16, 2016, http://www.bloomberg.com/news/articles/2016-02-16/corporate-bond-deals-take-off-with-apple-and-ibm-tapping-market.

[5] SIFMA, http://www.sifma.org/research/statistics.aspx.

[6] Mizrach, supra.

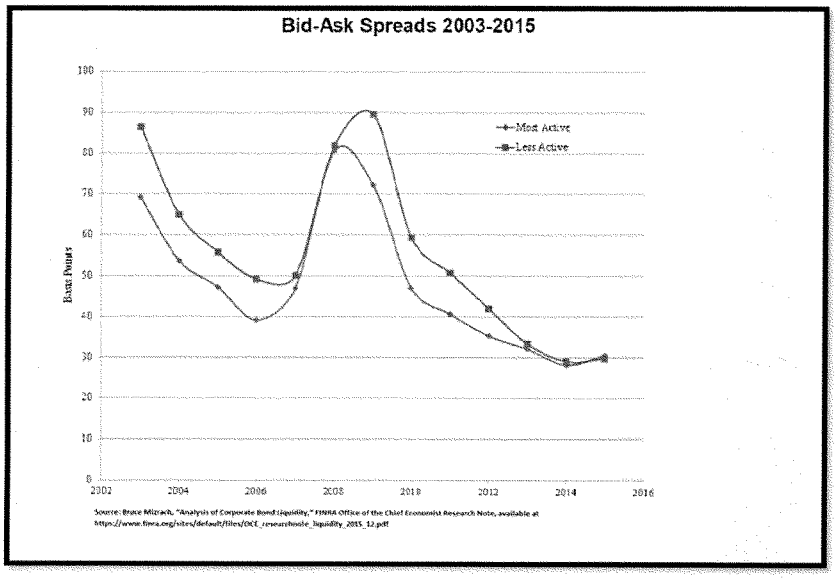


The securitization markets are also functioning reasonably well. Securitized product issuance rebounded nicely since the passage of the Dodd-Frank Act. And while it peaked at $225 billion in 2014, at $194 billion in 2015 it is largely in line with issuance in the early 2000s.[7] Instead, regulators have been concerned about frothy securitization markets and weaker underwriting.[8]

[7] SIFMA, http://www.sifma.org/research/statistics.aspx.

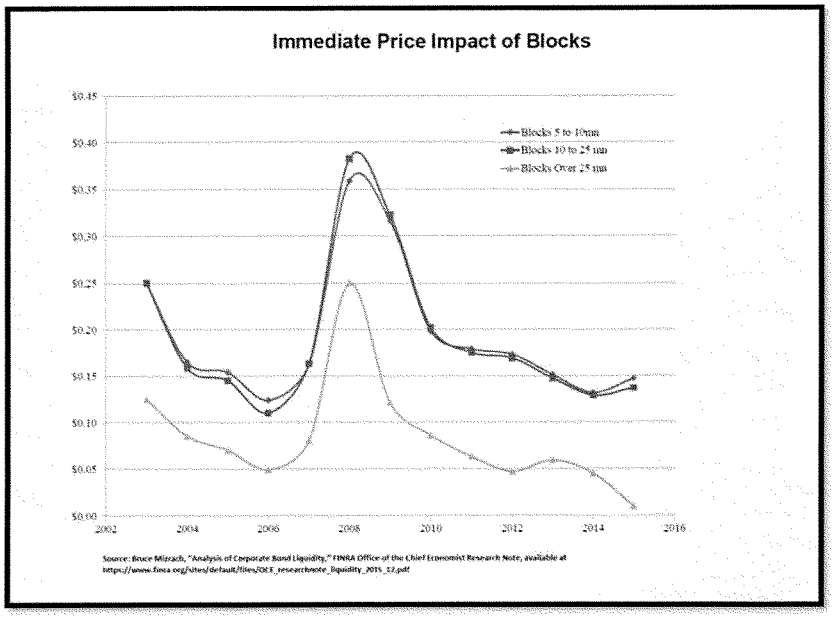
[8] See, e.g. Jeremy Stein, "Overheating in Credit Markets: Origins, Measurement, and Policy Responses," Feb. 7, 2013, http://www.federalreserve.gov/newsevents/speech/stein20130207a.htm; Lawrence Delevingne, "Blackstone: High-yield bonds, leveraged loans still 'frothy,'" June 2 2015, http://www.cnbc.com/2015/06/02/blackstone-high-yield-bonds-leveraged-loans-still-frothy.html.; Matthew Boesler, "Yellen Sees Risk of Bubbles in Leveraged Loan Market," *Bloomberg News*, July 15, 2014, http://www.bloomberg.com/news/articles/2014-07-15/yellen-sees-risk-of-bubbles-in-leveraged-loan-market.

Trading in the secondary market also continues to perform as well or better, in most key respects, than prior to the crisis.[9] Bid-ask spreads in corporate bond markets are down to around 30 basis points in 2015 for both the most active and less active markets.[10] This is down not only compared to the height of the crisis of 90 basis points, but even compared to the pre-crisis low of 2006, when spreads were approximately 40 basis points for the most active markets and 50 basis points for less active markets.



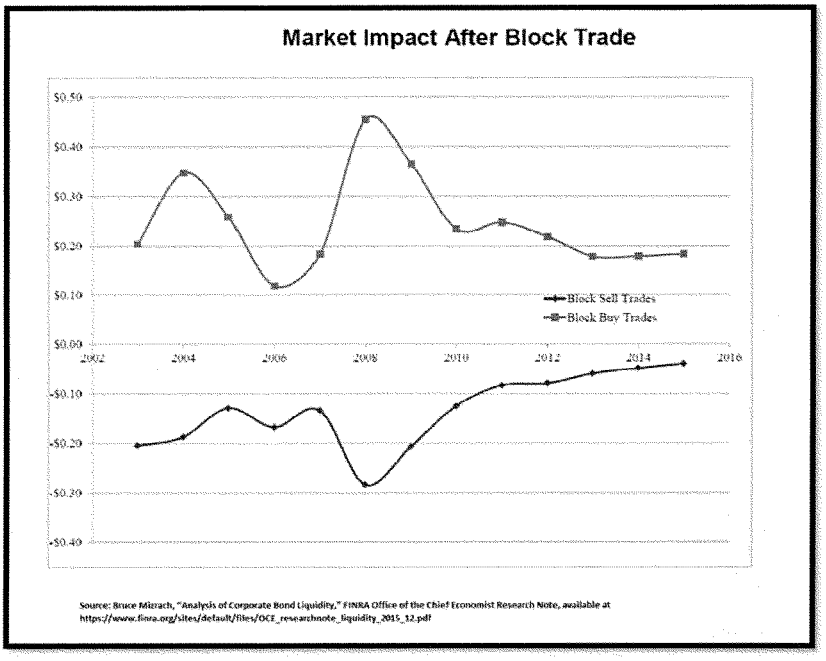
As of 2015, the price impact of blocks trades, another good measure of trading costs and liquidity, is very similar compared to pre-crisis lows.[11] (See figure below.)

[9] Other new risks may have entered, such as macroeconomic credit risks.
[10] Mizrach, supra, Figure 13.
[11] Mizrach, supra, Figure 14; see also Dudley, supra, Exhibit 8.



Market effects of block trades also appear better than ever. Price changes several trades after the immediate trade are considerably smaller than prior to the crisis.[12] (See figure below.)

[12] Mizrach, supra, Figure 15.



Notably, average trade size is down, from between $700,000 and $800,000 in the early 2000s to about $500,000 more recently.[13] The reason for this is not clear, although it may be related to changing market structure. However, this does not appear to have affected liquidity as measured by indices such as the bid-ask spread.

[13] Dudley, supra.

Notably all measures of trading costs have been coming down since the introduction of TRACE reporting in 2002.[14] To sum up, in the words of New York Fed President William Dudley, "there is limited evidence pointing to a reduction in the average levels of liquidity."[15]

Reforms Counter What Paul Volcker Calls the "Liquidity Illusion"

Yes, dealer inventories of corporate and foreign bonds are down since the crisis.[16] And anecdotally, we have heard that some traders say the markets "feel" different from 2005. This development may, in fact, be a good thing, considering that what followed was a leveraged-fueled bubble that resulted in massive mispricing of assets, incorrect evaluation of liquidity risk, and ultimately the most illiquid markets in decades.[17]

Recently, some have expressed concern regarding what will happen when markets hit the next "air patch."[18] For example, if the Federal Open Markets Committee were to raise interest rates, values of issued fixed rate debt would decline, and investors could wish to sell. If dealers are not able to take large positions, what would happen to the investors who want to sell? The hypothesis is that a liquidity crisis will result and investors will be unable to sell.

But the claim that absent Dodd-Frank and Basel III dealers would prevent or significantly reduce large market movements has little empirical support. First, dealers simply do not "catch the falling knife."[19] Put another way, even if the dealers theoretically could take the other side of a large trade (which they still may be permitted to do under existing rules), the same business

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[14] Mizrach, supra at 12, fn 8, citing to Amy K. Edwards, Lawrence Harris, & Michael S. Piwowar, "Corporate Bond Market Transparency and Transaction Costs," 62 *J. of Fin.* 1421 (2007).
[15] Dudley, supra.
[16] Tracy Alloway, "Digging into dealer inventories," *FT Alphaville*, Sept. 11, 2013, available at http://ftalphaville.ft.com/2013/09/11/1626462/digging-into-dealer-inventories/#.
[17] See Dudley, supra.
[18] Mohamed El-Erian, A New Mindset for a Shifting Global Economy, BloombergView, Jan. 24, 2016, http://www.bloombergview.com/articles/2016-01-24/a-new-mindset-for-a-shifting-global-economy.
[19] See, e.g., Levine, supra.

reasons that other investors want out of the position often make dealers unwilling to take the position. In fact, lower inventory and higher capital may also help dealers step in when it actually makes sense to do so.

The second fallacy of this make-believe liquidity crisis example is that it confuses trading volumes with liquidity. Liquidity is the ability to get into and out of a position quickly and efficiently; it is not the same as guaranteeing a price. Lulled into a sense of complacency by high volumes, market participants may mistakenly believe that they can get out at *any* time, in *any* quantity, under *any* market circumstance. Former Federal Reserve Chairman Paul Volcker calls this the "liquidity illusion." This illusion has several real impacts. Most importantly, we lose the accountability for investment decisions that is so important for the capital markets to efficiently allocate resources to the real economy.[20] Instead, we become at risk of a speculative bubble building and exploding. This is precisely what happened in 2008.

Fortunately, as NY Fed President Dudley and other points out, the changes put in place by the Dodd-Frank Act and consistent with the Basel Committee have made our financial system more stable and resilient, while continuing to enable it to serve the financing needs of the real economy.[21] Risks cannot be as large, funding cannot be as fickle, and losses must be covered by an increased level of shareholder equity. Indeed, some remain concerned that not enough has been done.[22] Ultimately, the aim is for financial markets to absorb the costs they impose on society and ensure their behavior more accurately reflects market signals. If some, despite the

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[20] Yalman Onaran and Dakin Campbell, Did Bank Rules Kill Liquidity? Volcker, Frank Respond, Oct. 20, 2014, http://www.bloomberg.com/news/articles/2014-10-20/did-bank-rules-kill-liquidity-volcker-frank-respond.
[21] Dudley, supra.
[22] See Deborah Petersen, "Anat Admati: Are Banks Safe Now? A scholar and a former regulator both warn that safeguards are lacking to prevent another financial crisis," *Insights by Stanford Business*, May 19, 2015, https://www.gsb.stanford.edu/insights/anat-admati-are-banks-safe-now.

data, still feel that the price of liquidity remains too high, perhaps they have identified a market opportunity: new capital should enter the market and lower the price. That is what it means to have competitive capital markets.[23]

Going Forward, Policymakers Need to Increase Transparency, Finish the Job, and Respond to Evolving Markets

This is not to say that everything is perfect today. The real question is whether the changes to date have done enough. Important areas of the fixed income markets continue to require reform. Below are several areas in need of attention.

Transparency in the Fixed Income Markets Should be Significantly Increased

Transparency has long brought tremendous benefits to the markets and investors. For example, the TRACE reporting system for corporate bonds and securitized products brought costs down dramatically since its introduction in 2002.[24] Forthcoming proposed changes to increase transparency regarding the costs investors pay in these markets have earned bipartisan support.[25] Separately, a Joint Report by the U.S. Treasury Department and other regulators

[23] See Hon. Kara M. Stein, The Volcker Rule: Observations on Systemic Resiliency, Competition, and Implementation, Feb. 9, 2015, https://www.sec.gov/news/speech/volcker-rule-observations-on-systemic-resiliency-competition.html.
[24] See Edwards et al, supra.
[25] See Andrew Ackerman, "New Bond Rules Target Large Broker Fees," *The Wall Street Journal*, Feb. 18, 2016, http://www.wsj.com/articles/new-bond-rules-target-large-broker-fees-1455830010; see, e.g., Hon. Dan Gallagher, "A Watched Pot Never Boils: the Need for SEC Supervision of Fixed Income Liquidity, Market Structure, and Pension Accounting," March 10, 2015, https://www.sec.gov/news/speech/031015-spch-cdmg.html.

called for greater transparency into the market for U.S. Treasury debt.[26] The tri-party and bilateral repo markets are also in need of significantly enhanced transparency.[27]

Academics, regulators, and advocacy groups have specifically called for more transparency regarding the institutions active in the fixed income markets.[28] I join in those calls and urge the Securities and Exchange Commission (SEC) to move faster on reimagining and rewriting its guide to financial sector disclosures. Greater transparency can also be brought to Volcker Rule compliance.

Congress should also be commended for requesting in the recent omnibus appropriations bill that the Securities and Exchange Commission (SEC) study the fixed income markets, including impacts of the Dodd-Frank Act and Basel III. I would urge, however, that such a study include the other independent regulatory and monitoring agencies as well. They have a role in monitoring and overseeing fixed income markets and institutions, and may have important insights to contribute about new and emerging trends.[29] Instilling a culture of cooperation is also

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[26] U.S. Department of the Treasury, et al, *Joint Staff Report: The U.S. Treasury Market on October 15, 2014*, July 13, 2015, https://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2015.pdf.

[27] Viktoria Baklanova, Cecilia Caglio, Marco Cipriani, Adam Copeland, The U.S. Bilateral Repo Market: Lessons from a New Survey, Office of Financial Research, Jan. 13, 2016, https://financialresearch.gov/briefs/files/OFRbr-2016-01_US-Bilateral-Repo-Market-Lessons-from-Survey.pdf.

[28] See Henry Hu, Disclosure Universes and Modes of Information: Banks, Innovation, and Divergent Regulatory Quests, 31 Yale J. on Reg. 565 (2014); Hon. Kara M. Stein, Remarks before the Peterson Institute on International Economics, June 12, 2014, https://www.sec.gov/News/Speech/Detail/Speech/1370542076896; Hon. Michael Piwowar, "Remarks before the Exchequer Club," May 20, 2015, https://www.sec.gov/news/speech/remarks-before-exchequer-club-washington-dc.html; Letter to Hon. Thomas Curry, et al, from Americans for Financial Reform, Dec. 17, 2015, http://ourfinancialsecurity.org/2015/12/letter-to-regulators-the-public-deserves-more-transparency-on-volcker-rule-implementation/; Center for American Progress, Report of the Commission on Inclusive Prosperity, Jan. 15, 2015, 91-92, https://cdn.americanprogress.org/wp-content/uploads/2015/01/IPC-PDF-full.pdf.

[29] This might include the interactions between more liquid CDS markets, the growth of ETFs, and the cash bond markets, as well as increased electronic trading in fixed income markets. See "Liquid Leak," *The Economist*, Feb. 20, 2016, http://www.economist.com/news/finance-and-economics/21693245-can-weak-markets-be-explained-changes-bank-balance-sheets-liquid-leak?frsc=dg|c; Liquidnet Launches Fixed Income Dark Pool to Centralize Institutional Trading of Corporate Bonds," September 28, 2015, http://www.liquidnet.com/#/news/liquidnet-launches-fixed-income-dark-pool-to-centralize-institutional-tradi/.

essential for the U.S. to maintain a flexible approach to financial markets and will ensure that the public and their representatives will benefit from more information.

Congress and Regulators Should Be Proud of the Changes Put in Place and Finish the Job

The stronger performance by the U.S. banking sector as compared to the European banking sector highlights the value of the changes the U.S. has put in place, including a stronger leverage ratio, the Volcker Rule, and resolution authorities. European banks remain thinly capitalized and deeply involved in higher risk fixed income trading.[30] European policymakers even moved last summer to weaken the capital treatment of securitizations.[31] Perhaps unsurprisingly, markets are now punishing European bank stocks and their contingent convertible (co-co) debt, a potential reflection of skepticism that remains around European banks' ability to sustain losses and remain solvent.

Fortunately, the Federal Reserve Board has imposed U.S. financial stability requirements on foreign branches and operations in the U.S., allowing us to be moderately less concerned about shocks delivered by their failure. These regulations, under attack by European regulatory and trade negotiators, were sorely needed, as some of the largest foreign banking organizations ran *negative* capital in the U.S. under pre-Dodd-Frank Act regulation.[32] That is, they had more liabilities than they had assets in the U.S. With new regulations in place, firms have had to create intermediate holding companies and meet U.S. capital and liquidity rules. This example

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[30] Martin Wolf, "Banks are still the weak links in the economic chain," *Financial Times*, Feb. 16, 2016, http://www.ft.com/intl/cms/s/0/a97efd1e-d34c-11e5-829b-8564e7528e54.html#axzz40psuCjY5.

[31] Boris Groendahl, John Glover and Rebecca Christie, Banks Set for Asset-Backed Debt Relief in EU Overhaul, *Bloomberg News*, Aug. 21, 2015, http://www.bloomberg.com/news/articles/2015-08-20/eu-said-to-seek-lower-capital-charges-for-simple-securitizations.

[32] See Simon Johnson, "Two Steps Forward and One Step Back for the Federal Reserve," Economix Blog, *N.Y. Times*, Feb. 20, 2014, http://economix.blogs.nytimes.com/2014/02/20/two-steps-forward-and-one-step-back-for-the-federal-reserve/?_r=0; Marc Jarsulic and Simon Johnson, How a Big Bank Failure Could Unfold, May 23, 2013, Economix Blog, *N.Y. Times*, http://economix.blogs.nytimes.com/2013/05/23/how-a-big-bank-failure-could-unfold/

reflects the increasing regionalization of the global banking business, which in part reflects the continued reliance on national governments to resolve, or rescue, failed banks. The United States will maintain a global competitive edge in banking for a long time to come.

Regulators must, however, finish the implementation of the Dodd-Frank Act. For example, the movie "The Big Short" reminds us that we still need to implement the provisions of Dodd-Frank Act that ban the conflict-ridden behavior that corrupted our securitization markets. Similarly, I would urge Congress *not* to adopt the bills under consideration today by the Subcommittee. They open up unnecessary and damaging loopholes to common sense principles, such as "skin in the game" risk retention and the Volcker Rule separation between private funds and banking entities. Many of the ideas have already been rejected by the regulators as unwise and unnecessary.

It goes without saying that fully funding regulators and reducing the challenges that regulators face in adopting new rules further facilitates their ability to act protect the American taxpayer. It is also important to remember that as regulations try to accommodate the quirks of particular firms or industries, they become more complex and harder to enforce. Sometimes, compliance is simply the best approach.

Thank you, and I would be happy to answer any questions.

Testimony of Richard A. Johns

On Behalf of the Structured Finance Industry Group

Before the United States House of Representatives

Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing Entitled

The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations

February 24, 2016

Introduction

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises: I want to thank you for holding this morning's hearing on *The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations*. My name is Richard Johns and I am here to testify on behalf of the members of the Structured Finance Industry Group ("SFIG").

Founded in March 2013, SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. With approximately 350 institutional members, SFIG's membership represents all sectors of the securitization market including investors, issuers, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers and trustees.

SFIG's membership believes that securitization is an essential source of funding for the real economy, representing $1.6 trillion, or nearly 30% of America's roughly $6 trillion of annual bond issuance.[1] Securitization connects investors with desired investments and provides consumers and businesses with access to funding and capital. Securitization provides economic benefits that can increase the availability and lower the cost of credit to your constituents' households and businesses.

Although most financial regulation inevitably has some effect on liquidity, as an organization covering the entirety of the structured finance market, I'd like to devote the majority of my time today to discussing a few global rules that affect all asset classes, including: (1) the new liquidity-specific rules that U.S. regulators implemented late in 2014, also known as the Liquidity Ratio ("LCR") rules, (2) European and International regulatory efforts to create standards for high-quality securitizations ("HQS") that would receive preferential capital treatment if certain conditions are met, and (3) the new Basel III capital rules that were adopted by the Basel Committee on Banking Supervision ("Basel") that increase capital standards for bank balance sheets, (4) the new Fundamental Review of the Trading Book ("FRTB") rules that increase capital for the trading book that Basel finalized in January of this year. All of these rules, particularly when combined, pose a serious threat to securitization as a critical source of funding for the real economy.

We believe that the new LCR rules are misguided, and cause concern in several respects. First, and most concerning, LCR does not treat any tranche of any class of asset-backed securities

[1] Securitization Provides Meaningful Funding to the Real Economy, Moody's, March 11, 2015, at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_1003586

("ABS") as High Quality Liquid Assets ("HQLA"). Essentially, regulators have deemed all ABS products illiquid.

According to available evidence, this blanket exclusion is unwarranted. High quality ABS are, by any measure, among the most liquid assets that a bank can hold. In fact, investment-grade credit card and automotive ABS generally performed better than investment-grade corporate debt during the crisis, which was granted HQLA status by U.S. regulators. Second, since the crisis, the implementation of various Dodd-Frank requirements, such as implementation of risk retention requirements, disclosure changes under Regulation AB II, or changes to Rating Agency protocols, has created significant changes across practices of the entire securitization industry. If these changes have any value at all, then how can an ABS security previously deemed to have zero liquidity value, still be deemed to have zero value after the implementation of Dodd-Frank. Effectively we are being told that "zero plus something of value = zero." Essentially Basel - and indeed our own regulators - are saying that post-crisis changes enacted under Dodd-Frank are worthless for capital and liquidity purposes. And third, under some circumstances, LCR treats committed liquidity and credit lines as more detrimental to a bank's liquidity than justified.

The Basel III Securitization Framework is also troubling. The final rule requires higher levels of capitalization than is warranted based on performance history, particularly when compared to competing forms of financing such as secured lending or covered bonds.

In addition, the recently finalized Basel FRTB rules applicable to all market-making activity, including securitization, may compound the effect on bank investment and capital levels if they are adopted by U.S. regulators in their current form.

In contrast, the European Union ("EU") and European Central Bank ("ECB") have recognized, through analysis, that both regulatory and structural impediments are inhibiting the return of the European ABS market. [2] In reaction, European policymakers have designed criteria for "high-quality securitizations," that would receive more appropriate capital requirements. Basel, and the International Organization of Securities Commissions ("IOSCO") have also undertaken a review of their securitization rules, and are proposing similar high-quality criteria for adoption internationally. At the same time, it does not appear that U.S. regulators will implement a similar capital plan for high quality securitizations. This would not only cause a bifurcated global ABS market, but it could also paradoxically cause the most liquid ABS market in the world to also have the highest capital charges.

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[2] The Bank of England & European Central Bank, *The case for a better functioning securitization market in the European Union*, May, 2014, at, https://www.ecb.europa.eu/pub/pdf/other/ecb-boe_case_better_functioning_securitisation_marketen.pdf

I will also address two of the three bills before the committee that attempt to provide surgical fixes to two asset class-specific issues, including: [3]

1. H.R. 4166, *the Expanding Proven Financing for American Employer's Act.* H.R. 4166 is an SFIG-supported (see appendix) bi-partisan bill co-sponsored by Congressmen Barr and Scott that creates a "qualified collateralized loan obligation ("QCLO") risk retention option for CLO's, and
2. A "discussion draft" bill sponsored by Congressman Hill that would create an exemption from the risk retention requirements for certain commercial real estate loans.

Returning to liquidity and capital, it is important to understand that the cumulative effect of these rules, if they remain unchanged, may be dramatic. As a result, securitization may become a less attractive form of finance than it should be, resulting in less available financing for the real economy.

We are already seeing that the new liquidity and capital rules have negatively impacted the market and reduced liquidity. There is a very real danger that these rules will restrict the supply of funding to an extent that could cause harm to important sectors of the real economy.

To support my conclusions, I will define liquidity, and I will explore how financial institutions manage liquidity, particularly in times of stress. I will then discuss the liquidity situation since the crisis and the effect on liquidity of some forms of regulation. Next I will compare the U.S. situation to developments in Europe, and I will follow that with a discussion of the likely effects of the Basel III Securitization Framework, the FRTB rules, and the liquidity consequences of the current accounting regime, when combined with economic stress. I will conclude by recommending specific reforms to promote liquidity.

What is liquidity?

Before going into detail about the impact of regulation on liquidity, I'd like to explain what I mean when I refer to "liquidity."

Generally speaking, a liquid asset is one which can be quickly bought and sold, in large quantities, usually with low transaction costs, without causing a significant shift in the price of the asset. An illiquid asset, by contrast, is an asset that is more difficult to buy or sell, connecting buyers and sellers takes more time and effort, and the final sale price of the asset is more difficult to predict. Because liquidity is desirable, liquid assets tend to command a higher price, thereby producing a lower overall return than less liquid assets of similar credit quality.

A liquid *entity* - as opposed to a liquid *asset* - is an entity that has enough liquid assets that it can absorb a short-term (or indeed long term) financial shock without becoming insolvent or

[3] SFIG does not have a position on H.R. 4096, as it does not directly affect the securitization industry.

unable to honor its outstanding obligations. By contrast, an entity with low level of liquid assets might have substantial total capital, but may be unable to raise money quickly to meet continuing obligations. Entities attempt to manage their liquidity by balancing competing demands: They must have enough liquidity to ensure the ability to meet outstanding obligations, expected and unexpected, but they do not want so much liquidity that they forego the relatively higher financial returns that are available from investing that liquidity in less liquid assets. Additionally, when financial entities invest too heavily in liquid assets, relative to longer term investment in other commercial and retail products, the supply of funding to the market from financial entities shrinks, thereby slowing growth in the economy.

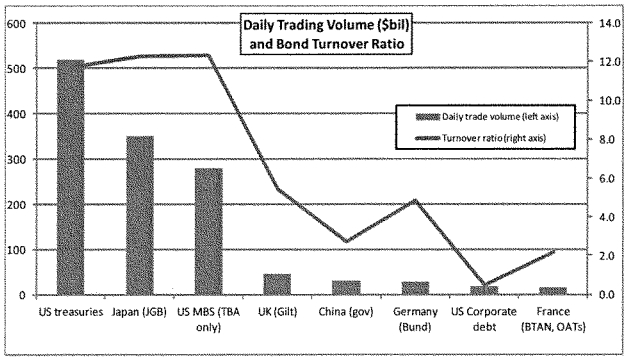
Liquidity is distinct from the concepts of funding and capital. Although all three concepts may relate to the solvency of an institution and its ability to deliver funding to the real economy, liquidity is primarily concerned with timing and price stability - how quickly, and how reliably, can an entity raise money if it needs to?

How do Financial Institutions Manage Liquidity?

Financial institutions manage their liquidity by a variety of means, including securitization. Cash is, by its very nature, the most liquid asset of all. Institutions acquire cash either by raising more funding than is needed to support their assets or by retaining surplus cash generated from operations. Based on cash flow forecasts and contingency planning, institutions may determine that some minimum amount of cash should be kept on hand.

Institutions also invest in liquid securities, which earn better returns than cash, but which are also fairly easy to convert back to cash should the need arise. The level of liquidity provided by these securities may vary. For instance, if cash is invested in US Treasury Notes—the most liquid security in the world with an effective cash equivalent amounting to 100 percent of par value - it is difficult to imagine that an investor is not going to be able to convert that security into cash on an almost immediate basis. If, however, the investor were to invest in government-sponsored enterprise ("Agency") debt, the third most liquid security in the world, the potential for immediate cash realization would be a fractionally lower amount. This sliding scale continues (with some overlap) through high quality municipal bonds, AAA-rated asset backed securities, high-grade corporate debt, lower-rated but still investment-grade ABS securities, investment-grade corporate debt, and ultimately equity investments.

Agency and Government Bond Trading Volumes



Sources: SIFMA, UK Debt Management Office, FRG Finance Agency, Japan Securities Dealers Association, AsianBondsOnline.com, Agence France Trésor Monthly Bulletin

If institutions do not have enough liquidity from cash and liquid securities, then they may borrow to increase their liquidity. But rather than raise expensive debt and suffer a low return from reinvestment of that debt in a liquid security, institutions may alternatively seek to avoid that "cost of carry" by establishing a committed line of credit from another financial institution. Because there may never be a need to draw on these lines of credit, they can often be far more cost-effective than incurring debt and reinvesting its proceeds.

Institutions also consider certain ordinary-course cash inflows to be an element of liquidity. Such cash inflows might include, for example, coupon payments on securities or installment payments on consumer or corporate loans that they made.

Institutions may also rely upon other forms of liquidity. For example, assets such as credit card loans or auto loans might be structured into AAA-rated securities ready to be sold to the market (Once securitized, those securities become highly liquid.). Or an institution might pledge assets or turn to a reserve bank/central bank line. While these sources of liquidity would never be considered "hard-dollar" liquidity, they are still rightly considered part of the total mix of *potential* liquidity for risk assessment purposes.

If we look to the behavior of financial institutions who managed their liquidity well through the financial crisis and look at what worked well to maintain bank liquidity, it is important to ensure that new regulation does not prevent these "tested tools" from working effectively again. In general, these financial institutions tended to manage their liquidity with a robust combination of liquid products, notably:

- Cash
- Treasuries

- Agency Debt
- Senior rated ABS
- Prime MBS
- Committed lines of credit

We recognize that during the crisis some financial institutions failed and were not able to fulfill their obligations to fund on their committed lines. Similarly, we recognize that lower rated and even some senior rated prime RMBS became illiquid as the housing market suffered, thereby impacting their liquidity value. However, provided that institutions managed liquidity on a prudent and diversified basis, all these categories of liquid assets provided strong defense against the kinds of insolvencies that we witnessed during the crisis. Most banks and financial institutions maintained robust liquidity policies prior to the last financial crisis, and most institutions responded to the crisis by further strengthening liquidity.

The financial sector's emphasis on liquidity dovetailed with the rational behavior of the US consumer - as the recession began, lower consumer confidence led to lower consumer spending and greater saving. This created a growth in deposit balances, and simultaneously there was reduced demand for loans as credit card, auto and mortgage spending reduced. The reduction of assets, coupled with growth in deposits allowed banks to build surplus liquidity as a basis for protecting themselves through an extended recessionary period. So notwithstanding the failure of significant financial institutions, which caused "ripple effects" reducing liquidity throughout the financial system, well-managed banks ultimately *increased* their liquidity and to a large extent became hoarders of cash.

When we look to future regulation it is important to recognize the stimulants that allowed banks to build liquidity in this fashion and appropriately "reward" those practices with regulatory treatment that continues to incentivize such behavior.

Bank Liquidity Post Crisis

In a perfect world, banks would maintain robust liquidity at all times and increase such liquidity during stress or recessionary scenarios. At the peak of the recession we would then hope that banks would begin to release that liquidity back into the system, enabling consumers and businesses to spend, rebuild confidence, and return the economy to a growth trend. In fact, from a profitability model, this ebb and flow of liquidity should fit a bank's business model very well. As the risk of defaults increases during a recessionary period, prior to its peak, one might expect banks to reduce their exposure to loans in favor of higher yielding low credit risk securities, essentially changing the mix of their assets from loans to securities, which in turn builds liquidity. Once the recession reaches its peak and starts to reverse, then default risk on loans starts to decrease in

parallel with credit spreads and yields on securities. At that point, a bank should want to readjust its risk position back towards the now more profitable loans by realizing the cash on those securities and lending it back to its customers, thus fueling a recovery. However, that anticipated release of liquidity did not happen during the most recent crisis to the same extent as it has in the past.

I submit that there are three primary reasons that banks were hesitant about releasing liquidity and expanding their loan portfolios:

1) Pending liquidity regulation:

In November 2009, the Basel Committee issued a consultation paper proposing more stringent liquidity requirements. The proposal would also have reduced banks' ability to rely, for liquidity, on many of the categories of investments that they had previously utilized so effectively, notably Agency securities, senior rated ABS and prime RMBS, and committed lines of credit. Finally, the proposal called for more strict regulatory supervision in the form of liquidity stress testing. The proposal created a great deal of uncertainty as to what would ultimately qualify as liquid investments and how liquidity would be assessed under a crisis. In the face of such uncertainty, banks remained cautious about releasing liquidity into the market.

2) Uncertainty relating to bank regulation more generally:

Irrespective of the specific rules relating to liquidity, since 2009 and continuing to this day, banks have faced an uncertain landscape in terms of where proposed regulation may end, creating a "moving goalpost" scenario for their lending strategies. The decisions that a bank makes today could have regulatory consequences under a future regime that has yet to be announced or even specifically contemplated. For example, changes to off-balance sheet accounting, risk retention, disclosure rules, implementation of the Volcker Rule, and potential changes to the regulatory capital regime, have all contributed to this landscape of uncertainty.

3) Capital requirements:

While much focus has appropriately been applied to capital standards, duplicative or unnecessary capital is not necessarily a good thing. The ability of an organization to release its liquidity back to the real economy, to stimulate lending, is dependent upon that organization's having sufficient capital to withstand the balance sheet's expansion with loan assets, which carry a higher risk-weighting than cash, treasuries or Agency securities. To the extent a capital regulation is burdensome without good reason, it keeps surplus capital on the balance sheet, preventing its use to support the return of that liquidity.

Further, in order to facilitate loan growth, there needs to be a balance of both capital (to support risk) and liquidity (to permit funding). Too much capital without surplus liquidity means financial institutions hold capital that is not able to earn a return. Too much liquidity without surplus capital and institutions end up with liquidity that cannot be used and has to sit on a balance sheet in zero risk assets, causing a carry cost to the bank. Neither of these situations is supportive of stimulating bank lending to help support and grow the real economy.

It is critically important that the cumulative effect of capital and liquidity regulations do not create such a capital shortfall that it prevents banks from supporting consumer lending through their balance sheets. So when we evaluate the impact of regulation on liquidity, it is important to recognize that even regulations that do not *specifically* address liquidity can nonetheless have a substantial *effect* on liquidity. As such, we must pay particular attention to capital regulations.

Liquidity Regulation

While much regulation affects liquidity to some degree, many of these impacts are indirect. For instance, risk retention requirements: the need to retain risk increases the amount of economic capital and possibly the amount of regulatory capital that an organization may be required to hold, which in turn increases the aggregate cost of issuance, potentially making issuance less attractive, and ultimately causing a reduction in supply. Yet investors are likely to be more confident purchasing a security from an issuer that retains some risk or "skin in the game," so demand for these securities is likely to increase.

This dynamic is common. We often see regulations that are intended to increase investor confidence, but they do so at some expense to the issuer. So regulations can have the effect of decreasing one driver of market liquidity while increasing another. The net effect will often be difficult to predict. These counterbalancing effects may very well be justified in ensuring we do not see markets overheat and become irrational, similar to pre-crisis markets, but that issue is open to reasonable debate with regard to each particular regulation.

There are no such tradeoffs, however, regarding one of the most significant U.S. regulations since the financial crisis - the implementation in the U.S. of the Basel III LCR. The LCR rule has reduced market liquidity, reduced investor interest in ABS, created additional liquidity in the system, and cut off a significant supply of committed credit to consumers and small businesses.

LCR was introduced initially as a response to the perceived need to improve short-term resilience in the liquidity risk profiles of banking organizations. To address this need, the Basel Committee on Banking Supervision first produced a consultation paper in 2009 and subsequently

published revised international liquidity coverage ratio standards as part of the Basel III reform package in 2013.

The goal of the rule is to make sure that banking entities retain enough "high quality liquid assets" in their portfolios to sustain a 30-day period of stress. The regulation specifies what assets may count as HQLA and sets different levels of liquidity credit for different types of assets (see exhibit below). For example, while cash is treated as 100% liquid, investment grade corporate debt is only counted at 50% of its face value, which reflects the regulators' assumption that corporate debt would be more difficult to monetize during a period of financial stress.

HQLA Designations Under the Final U.S. LCR Rule[4]

Type of Liquid Asset	Description	Haircut	Cap
Level 1	Highest quality and most liquid assets *Example: U.S. Treasury Securities*	No haircut	No cap
Level 2A	Relative price stability with significant liquidity *Example: GSE Securities*	15%	When combined with Level 2B liquid assets, cannot exceed 40% of total HQLA
Level 2B	More price volatility and less liquidity *Example: Investment grade corporate debt and exchange traded corporate equity securities*	50%	Cannot exceed 15% of total HQLA

U.S. prudential regulators finalized implementation of the LCR last year. The regulation has at least two major flaws:

1) Treatment of ABS and MBS as "non-liquid" under the regulation

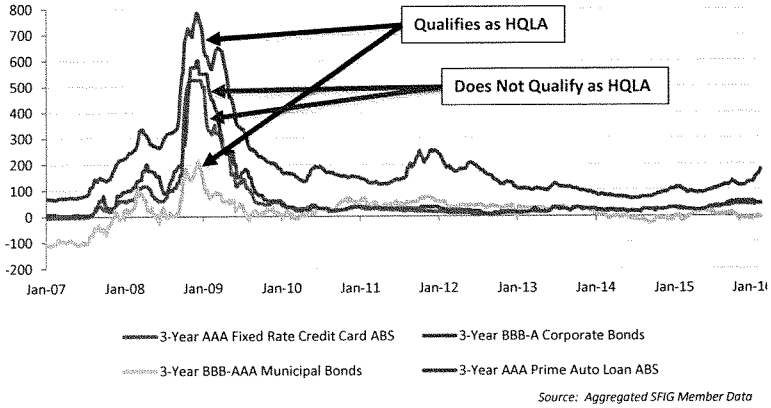
The U.S. implementation of LCR treats asset-backed securities (ABS) as *categorically* non-HQLA, regardless of performance and trading volume. This includes securities backed by prime-auto loans, prime credit card debt, student loans, and qualified ("QM") mortgages. So regardless of how much ABS a bank holds, and regardless of how safe or marketable those assets are rated, they count for nothing in the eyes of the regulators.

In determining which assets could be considered HQLA and how those assets would have to be discounted, it does not appear that the liquidity treatment was determined based upon the actual performance of each asset class during the crisis. The treatment of ABS - as non-liquid - is particularly striking when compared to that of corporate debt. As I noted above, investment grade

[4] SFIG's LCR Briefing Book, at: http://www.sfindustry.org/images/uploads/pdfs/SFIG_Briefing_Book_LCR.pdf

corporate bonds are considered high quality liquid assets for purposes of LCR compliance, though they are subject to a 50% haircut for assumed loss of value in the case of a crisis. Yet AAA rated "plain vanilla" ABS are considered non-liquid, notwithstanding that such assets have historically performed ***as well as or better*** than most investment grade corporate debt (as demonstrated by the chart below). Indeed, investors commonly refer to AAA-rated prime auto ABS as "treasury surrogates," or "cash equivalents."

Comparison of Card and Auto ABS Spreads to Corporate and Municipal Bond Spreads (2007-2016)



Source: Aggregated SFIG Member Data

For example, during the crisis, corporate investment grade debt experienced an 18% price decline at peak, compared to just a 13% decline in AAA automotive loan-backed securities and a 16% decline in AAA credit-card debt-backed securities. So while a 50% discount for investment-grade corporate debt may be extraordinarily conservative, there is simply no rationale for treating ABS as illiquid. Even during the recent financial crisis, ABS *as a category* retained a high degree of liquidity. Plain vanilla ABS generally maintained its ability to access markets, albeit at wider spreads, and many issuers had no need for government intervention programs (i.e. TALF) to maintain liquidity. At the very least, plain vanilla ABS should be entitled to the same 50% discount treatment as investment grade corporate debt. Clear evidence shows that even in a deep recession, price declines for AAA-rated ABS should not come close to 50%.

The regulation's treatment of all types of private label residential mortgage backed securities ("RMBS") is also inexplicable. Like all other ABS, RMBS are treated as illiquid, regardless of whether they contain QM loans that are considered so safe that the related sponsor is

exempted from all credit retention requirements under the newly adopted Credit Risk Retention Rule required by Dodd-Frank. The market considers such high quality, resilient mortgages highly liquid. Yet, in contradiction to the Credit Risk Retention Rule, from the perspective of the regulators, the inclusion of such loans in a security has no bearing on the liquidity of that security. We do not agree with this rationale – if an asset-class were deemed worth nothing from a liquidity perspective and subsequently improves its status by implementing Dodd-Frank requirements such as the inclusion of QM collateral, then how can "nothing" plus "something" still equal "nothing"? Regardless of whether or not one supports Dodd-Frank, it would seem that rules required by this law would have an intrinsic value from a liquidity perspective.

This inconsistent treatment of ABS has real consequences for the economy, and to the provision of funding to consumers and small businesses. ABS products are essential to support financing in many important sectors of the real economy. Historically, U.S. banks have been major investors in ABS, holding, for example, 25% of automotive loan-backed securities and 23% of credit card debt-backed securities (See chart in Appendix A). By treating ABS as illiquid, U.S. regulators have increased the risk that financing in these sectors may shrink significantly, creating a risk that automotive and other manufacturers slow growth or even decrease production, which could ultimately lead to higher unemployment.

I would also like to note, without going into too much detail, that the LCR is not the only problematic U.S. liquidity regulation. The net stable funding ratio ("NSFR"), a rule that addresses liquidity over a longer time horizon, is susceptible of the same criticisms because ABS and MBS are treated similarly to their treatment in the LCR. U.S. regulators have not, to date, finalized the NSFR for U.S. bank implementation. The NSFR could have a detrimental long-term effect on ABS liquidity if it is not calibrated to reflect the liquidity of the U.S. marketplace.

2) Treatment of committed lines under the LCR

The LCR rules' treatment of committed liquidity or credit lines to certain Special Purpose Entities ("SPE") is also problematic. As I noted earlier, one way that banks maintain liquidity is by maintaining committed lines of credit with other institutions. These lines can be drawn upon when the bank is stressed and needs short term cash to meet its obligations. But banks also extend such lines of credit to other banks, which can decrease their liquidity when drawn.

As demonstrated in the following table, the LCR uses different outflow rate assumptions for committed lines depending on the type of borrower and whether the line is for credit or liquidity.

Customer & Commitment Type	Outflow Amounts for Undrawn Commitments

Committed credit facilities to: • Wholesale customers and counterparties • SPEs that are consolidated subsidiaries of wholesale customers and counterparties that do not issue commercial paper or securities	10%
Committed liquidity facilities to: • Wholesale customers and counterparties • SPEs that are consolidated subsidiaries of wholesale customers and counterparties that do not issue commercial paper or securities	30%
Committed credit facilities to: • Financial sector entities (excluding depository institutions, depository institution holding companies and foreign banks) • SPEs that are consolidated subsidiaries of financial sector entities that do not issue commercial paper or securities	40%
Committed liquidity facilities to: • Financial sector entities • SPEs that are consolidated subsidiaries of financial sector entities	100%
Committed credit and liquidity facilities to all other SPEs	100%

Banks are exposed to a "double whammy" with respect to the treatment of committed liquidity facilities. Banks must assume a 100% draw on liquidity lines to financial sector entities or their consolidated SPEs. However, they are not allowed to assume ANY inflow from any credit of liquidity facility extended to it. We believe this outcome to be excessively punitive.

These concerns are exacerbated in the context of securitizations. In the original LCR proposal, a credit commitment to any SPE attracted a 100% outflow rate. We appreciate that the prudential regulators took into account our "look through" argument (i.e., that an SPE should attract the same outflow rate as its underlying assets) and, in the final rule, assigned a 40% rate to SPEs that are consolidated subsidiaries of financial sector entities. However, we do not believe that the caveat that such SPEs not issue CP or securities is at all appropriate. While we appreciate that the financial crisis experience with SIVs might have informed this decision, it has unnecessarily complicated the structuring of safe funding vehicles such as master trusts (used often for credit card and dealer floorplan securitizations).

In conclusion, the LCR rules represent a substantial and obviously intentional effort to reduce securitization as a form of funding, regardless of whether it be via committed lines of credit or via publicly placed debt of the highest caliber that historically have stood up well to recessionary factors. We can already see in the field of committed lines of credit, these regulations have nearly eliminated parts of that once vibrant market as a source of any liquidity. And we are seeing signs that the contraction of the ABS market will start to have an effect on important sectors of the real economy. To be clear, these are not unintended consequences—the market has provided clear warnings about the potential consequences of these regulations on multiple occasions. Rather, LCR is a deliberate attempt to contract the ABS and RMBS securities markets.

Changes to LCR in Europe and Adoption of the "Simple, Standard, and Transparent" Standard[5]

In stark contrast to the approach taken by U.S. regulators, European politicians have clearly begun to realize that the wrong kind of regulation or indeed an over-accumulation of any type of regulation can be counterproductive. They are actively pursuing ways to reinvigorate European securities markets, recognizing that the funding that these markets provide is crucial to their economies, including both small businesses and consumers. Both the European Central Bank and the Bank of England believe that securitization is a vital source of funding for the real economy.[6] These same regulators have also recognized that there are impediments – both structural and regulatory – that are currently constraining the return of the securitization market in Europe.

Basel, IOSCO, and EU policymakers understand that not all securitization is identical, and that many asset classes performed well and were in no way attributable or responsible for the financial crisis. There is a clear recognition that responsible lending and transaction standards have existed for several asset classes and product types since the securitization markets began in Europe, and accordingly, they have proposed criteria to designate such ABS under a "high-quality" banner categorized as "Simple, Standard, and Transparent" ("SST"). They believe that establishing this criteria, together with less onerous regulatory treatment of transactions meeting the criteria, could help stimulate a return of liquidity to the EU ABS market. In particular, the European Commission on Banking and Finance has proposed that capital requirements for SST qualifying ABS be less onerous, which should theoretically promote liquidity. This proposal is now before the European Parliament, and at some point, is expected to be adopted.

In essence, this SST concept seeks to address comments that have been made globally in a plethora of regulatory comment letters. Industry participants have argued that a "one size fits all" approach was inappropriate and that well-performing and liquid asset classes should not be unduly burdened as a consequence of issues associated with other asset classes. In other words, having

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[5] SFIG has generally used the term high-quality securitization ("HQS"), throughout this testimony. International regulators also refer to HQS as simple, standard and transparent ("SST"), and simple, transparent and comparable ("STC").

[6] The Bank of England & European Central Bank, *The case for a better functioning securitization market in the European Union*, May, 2014, at, https://www.ecb.europa.eu/pub/pdf/other/ecb-boe_case_better_functioning_securitisation_marketen.pdf

thrown out the baby (or in this case, several babies) with the bathwater, European policymakers are now trying to correct those actions.

The European proposals are admittedly not perfect.[7] Nevertheless, the principle behind SST—identifying a class of high quality securities and subjecting them to a more appropriate regulatory treatment—is sound.

Additionally, recent consultative papers have contemplated capital relief for those EU ABS that meet the SST designation, which would thereby increase the return on capital for banks investing in EU ABS. And on a similar basis the EC (under the Capital Requirements Regulation) has afforded certain EU ABS the HQLA status with applicable caps and haircuts for ABS that meet similar criteria. These are just a few examples of the striking disparity between the European and U.S. regulatory approaches on this issue.

At present, banks are subject to a patchwork of inconsistent regulations around the world, which is not a sustainable situation over the long term. However, with Basel and IOSCO taking a similar approach of identifying SST transactions in their own project, there is growing momentum for these initiatives to eventually become global, and at the very least, a consistent European (and likely global) approach may be emerging, with the U.S. alienated from this process by virtue of its non-adoption.

Of extreme importance, the proposal currently working its way through the European Parliament does not allow for U.S. collateral to qualify for use under their SST approach, thus only European banks buying European collateral will be able to take advantage of the designation and reduce the capital held against these liquid, high quality ABS.

European banks will be able to purchase high-quality European ABS with lower capital requirements, whereas U.S. banks will likely remain invested in U.S. products with higher capital requirements, and consequently a significantly lower return on capital. Faced with a clear differentiation where European collateral has a regulatory embedded advantage in its return on capital, it is inevitable that liquidity will be attracted to the higher returning assets, essentially draining some element of liquidity from the U.S. market. Similarly, in order to provide U.S. bank investors with the same return on capital as European banks, then U.S. issuance spreads will need to be wider than European levels, thus creating a cost burden that inevitably may cause a higher funding cost for the consumer or small business.

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[7] The complexity and ambiguity of the SST definition seriously limits its utility. Moreover, some of the criteria used are not necessarily relevant. The real goal of establishing a "qualifying" security should be to identify securities with a high credit quality. But the SST definition, as currently proposed, would be both over and under-inclusive of that goal. In particular, neither "simplicity" nor "standardization" necessarily imply credit quality.

As mentioned above, this divergence in regulatory standards may be further compounded at the international level. Basel and IOSCO's framework for securitizations that may be adopted by any participating company. Unlike the European proposal, the Basel/IOSCO proposal does not limit qualifying collateral to local jurisdictions, therefore allowing U.S. ABS to qualify. Should the recommendation be adopted by participating countries (i.e. China, Australia, and Japan) and not by U.S. regulators, then we are likely to see capital investment incentives for U.S. issued securities that favor foreign bank investment over U.S. bank investment. The failure of the U.S. to adopt regulations that may be accepted globally can create a division in the markets, whereby U.S. banks are incentivized to invest in higher yielding assets, while other investors may achieve the same return on capital by investing in safer lower yielding securities. Simply put, splitting a market reduces that market's liquidity.

Compare this outcome with what the U.S. is doing with Agency securities and the development of the Common Securitization Platform ("CSP"). Agency securities are the third most liquid security in the world, behind Japanese bonds and U.S. Treasuries. However, in lieu of two liquid securities, we are creating a single-security that, if implemented correctly, will be even more liquid and create a deeper marketplace. The United States' outlier status in the LCR and SST processes is likely to cause a fragmented global ABS marketplace.

We would strongly caution against the risk of creating a bi-furcated market with foreign investment being incentivized toward low risk U.S. assets. Not only does this create a reduction in liquidity due to the bifurcation of the market, but one must question from the perspective of the U.S. economy whether it is advisable to be creating an economy that relies on a significant part of its funding from foreign banks. We have already seen following the most recent financial crisis that foreign bailout funds would likely be contingent upon extended funds being invested at home. If the U.S. were to become over-reliant on foreign investment, then we would likely feel a deeper crisis as foreign investment funds are reduced.

If any of these contingencies come to pass, it would be a self-inflicted wound. The U.S. ABS marketplace is the most liquid ABS marketplace in the world, and it provides significant funding to the real economy (*e.g.* automobiles, credit cards, small businesses, capital equipment, solar power generation, housing, etc.)[8]. But the US LCR rules—in conjunction with less conservative rules for LCR in Europe and recent high quality initiatives—will inevitably create a situation where the far less liquid EU ABS market paradoxically becomes a better investment option than the liquid U.S. market. That would represent a serious regulatory failure.

In short, US markets are becoming less liquid, and some of that lost liquidity is being transferred to Europe. It seems unimaginable that the most liquid capital markets in the world may

[8] Securitization Provides Meaningful Funding to the Real Economy, Moody's, March 11, 2015. https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_1003586

lose liquidity to a market that is significantly less liquid, simply because U.S. regulators have concluded - contrary to the evidence - that our market is not sufficiently liquid.

At the very least, U.S. regulators should cooperate with the Europeans in developing a standardized regulatory approach to SST, both with regard to the definition of SST and with regard to less onerous requirements. They should do so for three reasons. First, and most importantly, a lower capital requirement for SST is good policy that will support liquidity in the securitization market. Although the definition of SST requires revision, the SST approach is a step in the right direction. Second, a global approach will reduce transaction costs and allow financing to flow more freely. And finally, if the U.S. waits to adopt these rules, they will already be well established around the world, and it will be too late to have any influence on their precise formulation. The expertise of U.S. regulators could be invaluable in ensuring that the SST approach is successful in protecting liquidity.

Capital Regulation

Even though capital regulation does not specifically target liquidity, it nonetheless has a substantial effect on liquidity. Consequently, it is worthwhile to understand the difference between capital and liquidity. While both affect the solvency of an institution, they are not the same thing.[9]

Capital is a measure of equity that an organization can use to protect it from future losses. It is primarily a credit risk tool. If an organization takes on business that exposes it to the risk of future losses, it should ensure it can protect itself from such potential losses should they ultimately manifest themselves. Such capital can be derived either externally, via capital markets via equity issuance or other capital markets products such as preferred stock, or internally/organically by the generation and retention of profit.

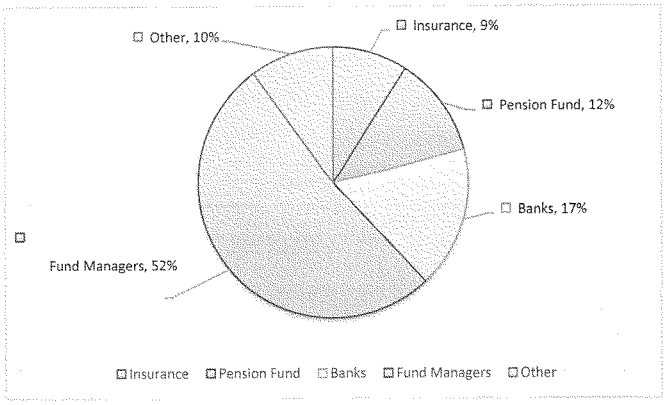
It should be very clearly noted that **capital is held primarily to protect an organization from unexpected losses.** This is very different from "accounting reserves" which may also be created by an organization as a future losses safeguard. However **accounting reserves are calculated based on expected losses**. They are created by writing down an allowance against future income and therefore create a deduction from profits which in turn flows to retained equity – however the creation of that allowance only occurs when you specifically see the loss likely to manifest itself on the horizon.

[9] It is worth noting that bank funding is also different from capital and liquidity. Funding has a very deliberate cash association. A financial institution may fund itself through a variety of means which may include sales of products for cash, issuance into capital or debt markets, loans from other institutions and deposits from consumer and corporate customers.

As I noted earlier, liquidity is a little less tangible. It may be derived from the issuance of capital products or other funding initiatives, but not every dollar funded creates a dollar of liquidity. Liquidity is more related to an organization's ability to raise cash at a time when it is needed. For instance, if a company were to raise a million dollars by issuing equity of $100,000 and taking a bank loan for $900,000, that would only translate into a million dollars of liquidity if it was maintained in cash or something easily converted to cash such as a US Treasury note. Were the million dollars to be invested in say plant and machinery, it would no longer be liquid and despite the fact that a million dollars had been raised, liquidity would effectively remain at zero.

Therefore, if capital rules require banks to hold increased capital against securitization positions, they will not be able to invest in as much ABS as before. As a result, there will be less liquidity in the marketplace. Although banks are not the only investors in ABS (see chart below), they make up enough of the market that the effect of capital regulation could be to significantly reduce liquidity. This effect may be exacerbated if the increase in capital for ABS and MBS is disproportionately large compared to the capital required for other comparable forms of finance such as secured lending or covered bonds. If the ABS or MBS markets are more limited because of the increased capital requirements applicable to some investors, then such businesses at worst may not be able to fulfill their financing needs, or at best be able to do so only at much higher costs.

U.S. ABS Investor Composition by Type: 2015



Source: Aggregated SFIG Member Data

The Basel III Securitization Framework, released late last year, is problematic in several regards. The details of the rules are complicated, but I would like to highlight a few features. First, Basel III requires banks to have extremely high levels of capital—far more than was required under

the previous Basel II framework. In some cases, for securitization positions, the capital required has increased by multiples of previous requirements.[10] The historical performance of ABS, particularly high quality ABS, does not justify such stringent requirements.

Another serious problem with the new rules is that they require banks to hold much more capital against ABS than they would be required to hold against the underlying assets. In other words, the rules discriminate against securitization. This is particularly striking because securitization is a way of *decreasing* risk through diversification and higher liquidity. As with the liquidity rules, it is hard to see this treatment as anything other than a conscious effort to contract the ABS securities market.

Whether Basel II capital requirements were too loose is a debatable question. But there can be little doubt that the Basel III Securitization Framework has gone too far. Previous capitalization requirements have been adequate to cover all losses, through the history of securitizations, with only one exception - U.S. subprime mortgages and some related and exotic resecuritization vehicles. But rather than revising Basel II to target those particular kinds of assets, Basel III represents a wholesale attack on securitization itself. The result will inevitably be less financing and less growth.

Fundamental Review of the Trading Book

Basel has also recently finalized Fundamental Review of the Trading Book (FRTB) rules that, if adopted, would pose a major threat to securitization in the United States. Although the likely impact of the rules is not yet precisely clear, it is clear that the FRTB rules would require broker-dealers to maintain far higher levels of capital in connection with their ABS market-making activities than they are required to under the current regulatory regime—perhaps more than twice as high. There is no evidence supporting the need for such high capital requirements. Moreover, there is no indication that the design of the FRTB rules took account of the cumulative effect of other regulations that increase capital requirements, such as Dodd-Frank and Basel III.

This rule is particularly troubling for the U.S. ABS market. One essential element of the U.S. ABS market is its use of the capital markets for *market-making*, or simply put, to buy, sell and trade ABS securities. Market-making by bank broker-dealers allows investors to have confidence that they can buy and sell securities as needed. However, if the FRTB rules are implemented in the U.S. in their current form, it may be unlikely that dealers and underwriters would be willing or able to carry the capital required by the rules. A more likely outcome would be that they would sharply curtail their trading of ABS or simply stop trading altogether. This

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[10] Results of the Comprehensive Quantitative Impact Study, Basel Committee on Banking Supervision, December 8, 2010, at, http://www.bis.org/publ/bcbs186.pdf.

contraction in the secondary market would drastically reduce the liquidity of ABS. Historically, one of the most important characteristics of ABS has been their high liquidity, and the removal of this confidence factor would surely decrease demand for these securities, leading to less issuance, higher cost for the consumer, and ultimately less financing for the real economy.

Securitization Accounting's Effect on Capital: FAS 166/167

While much of the negative impact from regulation is specific to the actual risk based capital regulations, one key change occurred under accounting standards through the post-crisis adoption of FAS 166 (true sale accounting rule) & 167 (consolidation for SPEs accounting rule).

FAS 166 & 167 standards require banks to record—on the face of a bank's balance sheet—existing and future transactions that were previously "off balance sheet," a process called "reconsolidation."

The essential test for reconsolidation under FAS 166 & 167 is whether the bank maintained control or management of the financial assets while also having a potentially significant financial interest in their performance. There was a great deal of debate about the decision to reconsolidate these assets, but it is fair to say that the majority of market participants supported transparency and the open disclosure of these assets on a sponsor's balance sheet. The bigger problem is that these standards have impacted bank leverage ratios and accounting reserves, ultimately creating redundant capital in the system. This has had a massive, unintended effect on the ability of banks to release liquidity.

Before explaining the redundancy in question, I want to emphasize that many of the transactions that were affected by this change in accounting were "plain vanilla" securitizations backed by credit card debt, prime auto loans, student loans, and prime mortgages, which included contractual obligations for institutional investors to absorb shortfalls in cash-flows by writing down the value of their investments. These are the same investors who took significant losses during the crisis, as we are all aware. The allocation of potential losses from these transactions was very clearly documented: usually the sponsor retained a small piece of risk, and after that retention was exhausted, losses would be allocated and absorbed by investors according to very deliberate contractual terms. Even though the sponsor was legally liable for a small portion of the risk on the whole portfolio, its reserves were calculated based on the entire portfolio.

It is certainly possible that some issuers might be tempted to support the cash flows of their transactions in order to protect investors from loss, which could help those issuers to maintain continued access to the capital markets throughout a recessionary environment. Such support would be beyond the contractual requirements or expectations of the markets – such as an unexpected loss - and it may perhaps have been appropriate for the joint regulators to assume *some* amount of regulatory capital would be useful to protect issuer reserves in instances where such a non-contractual action were to be taken.

Nevertheless, by bringing these assets back onto the face of the balance sheet—despite the need to make accounting reserves only for **losses that are expected**—the reserves were instead based on the amount of assets artificially disclosed as "owned" by the issuer.

Take for example a well-capitalized credit card issuer: at the height of the recession, when consumer credit card losses were largely tracking unemployment, you might expect to see a loss reserve approaching 10% of assets. The creation of that loss reserve requires a direct reduction of capital, as the reserve has to be funded by retained profit. Simultaneously, as the joint agencies required an additional 10% of risk based capital for a well-capitalized bank, the total net impact to capital from the consolidation of those assets amounts to over 20%. In other words, the amount of capital that is required, through the combination of accounting reserves and regulatory capital, reflects the assumption that over one in every five consumers will be completely unable to pay his credit card obligations, losing credit status and the ability to use credit.

There are two reasons that this level of retained capital is redundant:

1. It assumes that issuers will break contracts and provide 100% transactional support to their deals. Not only does the assumption that hundreds and thousands of incredibly precise documents will be broken run contrary to every other accounting treatment in the book, but;

2. It is also totally unrealistic from the perspective of an institution's fiduciary duty to its shareholders. In the unlikely event that losses were to approach 20%, which would threaten the capital adequacy of *any* issuer, it is unfathomable that issuers would still prioritize liquidity over the solvency of their institutions.

Although debate will doubtless continue over the specific details of risk based capital regulation, the industry would ask Congress to investigate this application of FAS 166 and 167 to loan loss accounting. A more simple adjustment to loan loss accounting rules could cause a major shift in overall issuance, which might return tens of billions of dollars of redundant capital back into the economy and stimulate *hundreds of billions* of dollars of new lending.

Basel's Framework for Step-In Risk

I would also like to briefly address Basel's recently proposed framework for dealing with step-in risk, which it defines as the "risk that banks would provide financial support to certain shadow banking or other non-bank financial entities in times of market stress, beyond or in the absence of any contractual obligations to do so." Basel clearly states that the proposal would apply to only unconsolidated entities; i.e., those entities outside the scope of regulatory consolidation. The proposal does not address how step-in risk would be incorporated into the current Basel

framework, including whether they would fall within Pillar 1 and/or Pillar 2, but we would presume that it would be addressed by additional capital requirements.

While we appreciate the need for appropriate capital requirements, we are concerned that any potential step-in requirements would not reflect the many changes that have been made to accounting rules and regulations in response to the financial crisis. For example, within the framework of FAS 167 consolidation decisions, the sponsor of a securitization must consider whether it has a significant implicit financial responsibility to ensure that a variable interest entity operates as designed. This determination must take into account the sponsor's concern regarding reputation risk if the variable interest entity does not operate as designed. Therefore, FASB rules already require that a sponsor of the securitization analyze "implicit" risk, including any potential reputational risk, when making consolidation decisions. If, through this analysis, entities are consolidated on balance sheet, banks would have to hold appropriately robust levels of capital as required by Basel III. We believe, therefore, that the combination of post-crisis accounting and regulatory reform renders additional capital requirements redundant and unnecessary for the unconsolidated entities that Basel is targeting.

The Cumulative Effect of Layered Regulations

Many of the regulations I've discussed today would be a concern in isolation. But the cumulative effect of all of these rules could have a detrimental effect to the $1.6 trillion in annual financing that securitization provides the U.S. economy. It is worth noting that while some reforms have been finalized, there are a number of rules that are still being implemented, and others that are still being proposed (such as the FRTB rule). That said, below are several observations we would highlight.

First, because ABS and MBS are not considered high quality securities, they do not contribute to banks' liquidity ratios, making it far less desirable for banks to hold them. Second, Basel III's capital requirements, outside of subprime RMBS, appear higher than is warranted based on historical evidence. Third, the accounting rules under FAS 167 require banks to hold even more capital against risks for which the banks are not even contractually liable. Fourth, FRTB will require many banks to hold yet more capital—the total amount is not clear, but it is likely to be multiples of what is required under the current regime.

On top of these affects, what is truly difficult to comprehend is the lack of credit given to Dodd-Frank reforms during development of international capital and liquidity standards. One purpose of Dodd-Frank was to shore up holes in the U.S. regulatory framework, and therefore mitigate the fallout from any future crisis.

Many of the Dodd-Frank rules meant to correct the perceived flaws in the ABS market have been finalized, such as disclosures under the SEC's regulation AB II and the joint regulators' risk retention rules, to name just two.

However, the same U.S. regulators who promulgated these rules also sit on the Basel and IOSCO committees that promulgated international capital and liquidity rules. Yet none of these international capital and liquidity rules, when tailored to the U.S. marketplace by our regulators, give credit to the controls installed by Dodd-Frank. Essentially, U.S. capital and liquidity rules ignore the controls installed by Dodd-Frank. Potentially much worse, the U.S. regulators have adopted considerably more stringent approaches to prudential regulations than international standards.

This is precisely why Congress, U.S. regulators and the industry must understand the cumulative effect of regulations. Regulation must strike the right balance between liquidity and a well-regulated U.S. ABS marketplace, or indeed whether we have created an unfair competitive advantage that favors European issuers over U.S. ABS issuers.

Specifically, such a review should be ongoing, examining the interaction of finalized and proposed rules in the same context to understand where the appropriate calibration should be made to balance liquidity and regulation.

European regulators have already undertaken such an analysis and begun to act upon its findings. Unfortunately, without such an analysis in the U.S., it is not hyperbole to say that the combined effects of regulation could be extremely detrimental to the American economy.

Proposed Legislation to Address Asset Class-Specific Regulatory Concerns

H.R. 4166, the Expanding Proven Financing for American Employers Act

The $285 billion CLO market is a key to a well-functioning commercial loan market which provides significant capital to businesses and fosters economic growth and job creation. By providing substantial credit capacity to the commercial loan market, CLOs generally serve to lower interest rates for corporate borrowers that may not have ready access to alternative capital markets financing. In fact, CLOs represent the largest non-bank segment of the commercial loan market.

As we stated in our December 8, 2015 letter to the Members of this Committee, SFIG supports H.R. 4166, a bipartisan bill introduced by Congressman Barr and Congressman Scott that creates a QCLO option to comply with CLO risk retention requirements. Under the legislation, QCLOs must meet strict criteria across six categories designed to enhance the alignment of interest between CLO managers and investors.

While we appreciate the difficult task that regulators had in promulgating the risk retention rules, SFIG members do not believe that the lead arranger/open market option for CLOs in the

final risk retention rule is a viable solution, and may decrease CLO issuance and increase costs for borrowers.

H.R. 4166 is a common sense solution that will allow the CLO industry to continue supporting real economy growth through investment in local businesses and communities, while also remaining true to the goals of risk retention.

SFIG stands ready to work with the members of this Committee to build the broadest consensus possible to support this approach.

Discussion Draft: To Exempt Certain Commercial Real Estate Loans From Risk Retention Requirements

The $1.2 trillion commercial real estate market provides significant funding for multifamily housing, office space, grocery stores and hospitals. As of the fourth quarter of 2015, CMBS accounted for roughly $600 billion in outstanding commercial real estate debt. The discussion draft creates an exemption for single-asset/single-borrower CMBS transactions, and modifies the b-piece risk retention option to allow the risk to be shared amongst two purchasers on a pari-passu basis.

As with any good law or regulation, there needs to be some alignment of interest and skin-in-the-game by issuers in order for investors to feel confident in purchasing an ABS or MBS. The degree of that alignment of interest is subject to debate.

Issuers, on the whole, would prefer the lowest cost and most efficient requirements in order to earn the best returns possible for their stockholders. Investors, in general, would prefer more protections in order to feel confident in their purchase, while at the same also earning an appropriate return on their investment.

While it is too early to give a definitive reaction to the bill, early indicators from SFIG's membership suggest that while our issuers are unanimously supportive of the bill, a majority of our investors are not.

Therefore, SFIG would recommend that a forum be established to create a consensus path forward for the industry on this discussion draft.

Conclusion: Recommendations to Responsibly Create Liquidity in the Financial Market

Based on the foregoing discussion, we request the following:

1. U.S. Regulators should be required to continuously review the effects of current and anticipated regulation on the securitization market. Regulators should also be required to publicly provide any analysis on the effects on the availability or cost of credit to consumers and borrowers. Specifically, U.S. regulators should be required to examine the Basel III Securitization

Framework, the FRTB, current U.S. Risk Based Capital Rules, take into account the rules established under Dodd-Frank, and adjust capital requirements to appropriate levels. A formal review mechanism should be created to conduct such a review and to consider ways in which rules should be calibrated to achieve regulatory goals, while limiting the impacts on market liquidity, consumers and business end users.

2. As was the case with municipal bonds, the definition of High Quality Liquid Assets, as used in the LCR rules, should be reexamined by U.S. regulators to give highly rated ABS and RMBS, a status at least equivalent to that of investment grade corporate bonds. We cannot emphasize this enough. Failing to respect the highly liquid nature of these securities would have severe detrimental effects on both liquidity and the real economy.

3. Committed lines of credit to security-issuing SPEs should not be categorically treated as 100% outflows for LCR purposes. Such treatment should be reserved for lines of credit committed to only the types of SPEs that are most vulnerable to market disruptions.

4. U.S. regulators should work with E.U. regulators to develop an internationally consistent and fully operable standard for "qualifying" securitizations. Consequently, the capital requirements for the related ABS and MBS (for both the trading and banking books) should be reduced to appropriate levels.

5. FAS 166/167 should be reexamined to ensure that capital is being held against contractual obligations, and it should be examined in the face of the additional capital that may be required under Basel's proposed Step-In risk rule. It is critically important that capital treatment reflects real economic risk.

6. Support H.R. 4166, as it creates a workable option for CLO risk retention. SFIG stands ready to help build the broadest possible consensus for this bipartisan bill.

7. Continue the dialogue on the discussion draft for CRE loans.

8. Congress should continue to monitor liquidity across the various market segments through additional hearings as Dodd-Frank, Basel and other rules are proposed and later enacted.

Thank you for the opportunity to testify before you today. SFIG stands ready to work with all Members of this Committee to find economic solutions that balance appropriate regulation with a liquid securitization marketplace.

Appendix

December 8, 2015

The Honorable Andy Barr
Congressman
1432 Longworth House Office Building
U.S. House of Representatives
Washington, DC 20515

The Honorable David Scott
Congressman
225 Cannon House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Congressmen Barr and Scott:

The Structured Finance Industry Group, Inc. ("SFIG") is a member-based trade industry group focused on improving and strengthening the broader structured finance and securitization market. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers and trustees.

SFIG urges House support H.R. 4166, the *Expanding Proven Financing for American Employers Act* ("Act"), a bipartisan bill that creates a workable risk retention regime for collateralized loan obligations ("CLOs").

The $285 billion CLO market is key to a well-functioning commercial loan market which provides significant capital to businesses and fosters economic growth and job creation. By providing substantial credit capacity to the commercial loan market, CLOs generally serve to lower interest rates for corporate borrowers that may not have ready access to alternative capital markets financing. In fact, CLOs represent the largest non-bank segment of the commercial loan market.

While we appreciate the efforts of the regulators, SFIG members do not believe that the lead arranger/open market option for CLOs in the final risk retention rule is a viable solution, and may decrease CLO issuance and increase costs for borrowers.

H.R. 4166 creates a risk retention requirement that applies to "qualified" CLOs ("QCLOs") that meet strict criteria across six categories designed to enhance the alignment of interest between CLO managers and investors. The Act is a common sense solution that will allow the CLO industry to continue supporting real economy growth through investment in local businesses and communities, while also remaining true to the goals of risk retention.

We look forward to working alongside Congressmen Barr and Scott to move H.R. 4166 forward.

Sincerely,

Richard Johns
Executive Director

cc: Members of the House Financial Services Committee

Testimony of Jeffrey Plunkett
On behalf of
Natixis Global Asset Management
Before the Capital Markets and Government Sponsored Enterprises
Subcommittee of the House Committee on Financial Services
February 24, 2016

Chairman Garrett, Ranking Member Maloney, Members of the Subcommittee, thank you for inviting me to testify today on behalf of Natixis Global Asset Management. My name is Jeffrey Plunkett, and I am the Global General Counsel and Executive Vice President for Natixis Global Asset Management. Natixis Global Asset Management is a wholly owned subsidiary of Natixis, a French bank that is the corporate, investment and financial services arm of Groupe BPCE, the second largest banking organization in France. Natixis operates a single branch office in New York and does not accept FDIC-insured deposits. BPCE, Natixis and each of their affiliates, including Natixis Global Asset Management and each investment manager affiliated with us, is considered to be a "banking entity" for purposes of the Volcker Rule's restrictions.

Asset managers play an important role in the global financial system, investing client funds in stocks, bonds, commodities and currencies. Through their clients' funds, they provide an important source of capital formation and liquidity to markets worldwide. They enhance the flow of capital from savers and investors, and increase the set of opportunities to individuals and businesses. They serve the interests of individual investors through public and private retirement plans, foundations, and registered investment companies, by managing ERISA pension, 401(k), mutual fund and personal investments. Innovative asset managers provide new products that help individuals save for retirement. Asset managers affiliated with banks also contribute a source of revenues that is not dependent on capital of the parent bank.

Natixis Global Asset Management brings together the expertise of multiple specialized investment managers based in Europe, the Americas and Asia to offer a wide spectrum of equity, fixed-income and alternative investment strategies. The firm ranks among the world's largest asset managers. Headquartered in Paris and Boston, Natixis Global Asset Management's assets under management totaled $870 billion as of December 31, 2015.

Natixis Global Asset Management's affiliated investment management firms (each, an "NGAM Adviser") and distribution and service groups include: Active Investment Advisors; AEW Capital Management; AEW Europe; AlphaSimplex Group; Aurora Investment Management; Axeltis; Darius Capital Partners; DNCA Investments; Dorval Finance; Emerise; Gateway Investment Advisers; H2O Asset Management; Harris Associates; IDFC Asset Management Company; Loomis, Sayles & Company; Managed Portfolio Advisors; McDonnell Investment Management; Mirova; Natixis Asset Management; Ossiam; Seeyond; Vaughan Nelson Investment Management; Vega Investment Managers; and Natixis Global Asset Management Private Equity, which includes Seventure Partners, Naxicap Partners, Alliance Entreprendre, Euro Private Equity, Caspian Private Equity and Eagle Asia Partners.

The Volcker Rule "Name-Sharing Prohibition"

Section 13 of the Bank Holding Company Act ("BHCA") was added by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), and is commonly referred to as the Volcker Rule. The Volcker Rule, and the Volcker Rule's final implementing regulations (the "Final Rule") contain, among other things, significant restrictions on the ability of banks, and investment managers affiliated with banks, to sponsor hedge funds and private equity funds. Notwithstanding the Volcker Rule's general prohibitions, Section 13(d)(1)(G) of the BHCA authorizes a banking entity to organize and offer a private equity or hedge fund, including sponsoring the fund, subject to compliance with certain conditions. One of those conditions is found at Section 13 (d)(1)(G)(vi), which provides that the banking entity may not share with the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the name. The Final Rule expands upon this prohibition, stating that a covered fund (the Final Rule's term for hedge funds and private equity funds) may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof) and also may not use the word "bank" in the name.

Unfortunately, this provision of the Final Rule is at odds with both industry practice and with the goal of providing clarity to investors about who is managing a covered fund. In our experience, most private funds (hedge funds and private equity funds) contain the name or a variation on the name of the investment management firm that advises the private fund. Thus, a fund managed by "ABC Investment Manager" might be called the "ABC Private Fund," which clearly distinguishes this private fund from other funds managed by other investment advisers.

This industry practice has been in place for many years, and serves the dual purpose of providing clarity to investors about who is managing the investor's money, as well as establishing brand equity for the investment adviser. In our experience, investors in private funds prefer to see the name of the fund manager in the name of the fund, which facilitates their investment review and provides clarity in reporting and tracking by the investor. It is worth noting that investors in private funds are typically sophisticated institutional investors, such as pension funds and endowments that are seeking to diversify their investments and manage risk, and are in all events required by law to be at least "accredited investors" meeting the financial and sophistication standards set by the U.S. Securities and Exchange Commission ("SEC").

As bank-affiliated investment managers are deemed "banking entities" subject to the Volcker Rule, NGAM Advisers and other bank-affiliated asset managers are now generally prohibited from using their name to help identify their private funds marketed in the U.S. This provision of the Final Rule puts them at odds with investors' desire for clarity – and at a competitive disadvantage with independent managers.

The situation is even more illogical when the bank-affiliated investment managers are branded separately from their parent bank or bank holding company. This is often the case when a bank

affiliate acquires previously established investment management firms, and maintains the name of the acquired firm under which it has previously operated. There are a number of other bank-affiliated investment management firms that operate in this manner. In the case of Natixis Global Asset Management, each of the NGAM Advisers operates under its own historical name and branding and, with only a couple of exceptions, none has Natixis or BPCE (or a variant) as part of its name or logo. Each NGAM Adviser is also separately registered with and regulated by the SEC and/or other regulatory agencies as required by its business.

We believe that compliance with the name-sharing prohibition of the Volcker Rule as currently in force risks confusion among investors and burdens firms that are affiliated with banks, leading to a lack of transparency for clients and a potential competitive disadvantage for bank-affiliated firms vis-à-vis their independent competitors.

Investor Clarity

The primary purpose of the name-sharing prohibition is to prevent investor confusion about who ultimately bears the risk of loss associated with investments in banking entity-sponsored hedge funds and private equity funds, and thereby limit the risk that investors will look to the affiliated bank to step in to protect investors. In this respect, the prohibition is very similar in concept to the limitations that bank and securities regulators historically imposed on the names of mutual funds advised by banks or bank affiliates. Significantly, however, those limitations were long ago removed as unnecessary and replaced with enhanced disclosures, even though the risk of investor confusion is much greater with retail investors than would be the case with investors in hedge and private equity funds, who under the securities laws must have a greater level of sophistication in order to invest in such funds.

Moreover, a number of Section 13(d)(1)(G)'s other conditions also address the risk for investor confusion about who ultimately bears the risk of loss associated with investments in such funds. Specifically, Section 13(d)(1)(G)(v) provides that the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the hedge fund or private equity fund or of any hedge fund or private equity fund in which such hedge fund or private equity fund invests. In addition, Section 13(d)(1)(G)(viii) requires that the banking entity disclose to prospective and actual investors in the fund, in writing, that any losses in such hedge fund or private equity fund are borne solely by the investors in the fund and not by the banking entity. The Final Rule also expands these required investor disclosures to provide, among other things, (i) that investors should read the fund offering documents before investing in the fund and (ii) that "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity".

These restrictions are more than sufficient to ensure that hedge funds and private equity funds sponsored by a banking entity are understood by investors to be separate from their sponsor and the affiliated bank or bank holding company. However, even in situations where the investment manager is branded totally separately from its affiliated bank (i.e., there is nothing in the name of the investment manager that is linked to the name of its affiliated bank), the literal language of Section 13(d)(1)(G)(vi) acts to prohibit the investment manager from

including its name as part of the name of the fund that it sponsors. As many private funds are logically named to include a reference to the investment manager that manages the investments, the "naming prohibition" contained in Section 13(d)(1)(G)(vi) simply serves to confuse investors and undermine effective marketing of investment products by bank-affiliated investment managers without providing any increased safeguards to investors or the affiliated bank.

Legislative Action is Necessary

H.R. 4096, "The Investor Clarity and Bank Parity Act" would, if adopted, make limited modifications to the Volcker Rule. It is a proposed technical amendment that would seek to clarify, and narrow to its apparent original intent, the scope of the Volcker Rule's overly broad name-sharing prohibition.

The name-sharing prohibition contained in the Volcker Rule was one of the most heavily commented upon aspects of the Volcker Rule. However, the regulatory agencies responsible for implementing the Volcker Rule determined that the "name-sharing restriction is imposed by statute" [1] and adopted that portion of the Final Rule as proposed. While the Final Rule did narrow the definition of covered funds, and thus the number of funds potentially subject to the name-sharing prohibition, it did not limit the name-sharing prohibition as many commenters had requested.

Natixis Global Asset Management has approached staff members of both the SEC and the Board of Governors of the Federal Reserve System ("FRB") regarding the application of the naming restrictions in the Volcker Rule to the NGAM Advisers. In our discussions, staff at both the SEC and the FRB have indicated that they appreciated our belief that the Volcker Rule – an expansive effort to regulate and protect the banking system after the financial crisis – was not intended to affect the naming of funds where the investment manager's name did not link the manager or the fund to its parent bank.

In November 2014, Natixis Global Asset Management also submitted a formal request for regulatory guidance on this issue to confirm our understanding. However, staff at both the SEC and the FRB expressed their belief that the language of the Volcker Rule legislation did not leave room for regulatory interpretation and that we would need legislative action to obtain relief from the strict naming restrictions in the Volcker Rule.

We question the necessity for any naming prohibition beyond prohibiting the use of the name of the affiliated bank or bank holding company or the word "bank" when a prohibition on bailing out hedge funds and private equity funds is in place and where there is disclosure that investors bear the risk of loss from their investments in such funds in any event. The prohibition on bailing out funds protects against the "too big to fail" problems of the financial crisis and the disclosure requirements provide the necessary warning to investors of the risks involved.

[1] See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 at 5717-18 (Jan. 31, 2014).

Economic Impact of Regulation

Natixis Global Asset Management supports common-sense regulation and believes steps were necessary following the financial collapse to prevent another from occurring. However, we believe in smart targeted regulation rather than overly broad regulation that can have unintended consequences that create unnecessary risk and harm both the markets and investors.

The recent global financial crisis was both a credit crisis and a liquidity crisis. Much of the financial regulation written in the wake of the crisis was designed to mitigate credit risk. While the regulation has worked to mitigate some of the credit risk that led to the crisis, it has had the unintended consequence of increasing liquidity risk (reducing liquidity). Legislation and rulemaking like Dodd-Frank and Basel III have improved the credit standing of banks and other lending/depository institutions. However, these rules have caused banks to pull back or eliminate market-making and other intermediary functions. Bank "desks" no longer stand between buyers and sellers, a risk, liquidity, and volatility mitigation function banks provided for years. By increasing capital and restricting market activities, Dodd-Frank and Basel III have had the unintended consequence of increasing liquidity risk as credit risk has been reduced.

The emphasis of Dodd-Frank and Basel III on reducing credit risk has also caused a squeeze on the creation of credit, which has harmed economic growth. Credit growth is the life-blood of economic growth, especially in periods where population growth, wage growth, and productivity growth are all either sub-par or non-existent. When banks are forced to increase equity and improve balance sheets, the easiest first step for banks to achieve this is to reduce lending. Loans that are not made cannot default. As a result, too much emphasis placed on balance sheet quality will impair credit creation and, by extension, economic growth. The lack of credit growth currently in the market is one of the main reasons why our recovery has been slower than hoped and our wage growth and employment continue to lag.

Conclusion

H.R. 4096 is a technical amendment that has been carefully crafted to protect the core values of the Volcker Rule and amend this provision of the Volcker Rule in a very limited way. It has been narrowly tailored to retain the prohibition on banking entities from using the name of the affiliated depository bank or bank holding company or the word "bank" as part of the names of hedge funds or private equity funds they organize and offer, while permitting a *separately branded* investment adviser to share its name or a variation of its name with the funds it sponsors. As currently drafted, the naming prohibition deprives investors of clarity and burdens the industry without providing increased safeguards to investors.

Mr. Chairman, we urge Congress to adopt H.R. 4096.

Thank you for the invitation to participate in today's hearing.

House Financial Services Committee, Subcommittee on Capital Markets and Government Sponsored Enterprises
Hearing on:
"The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations"

February 24, 2016

Written Testimony of the
Commercial Real Estate Finance Council

Executive Summary

The Commercial Real Estate Finance Council ("CRE Finance Council" or "CREFC") appreciates this opportunity to provide the Subcommittee with testimony on the impact of Dodd-Frank and Basel III on securitizations and the fixed income market.

The CRE Finance Council is the collective voice of the entire $3.5 trillion commercial real estate finance market. Its members include all of the significant portfolio, multifamily, and commercial mortgage-backed securities ("CMBS") lenders; issuers of CMBS including banks, insurance companies, Government Sponsored Enterprises (GSEs), and private equity funds; loan and bond investors such as insurance companies, pension funds, specialty finance companies, Real Estate Investment Trusts ("REITs"), and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers. Our industry plays a critical role in the financing of office buildings, industrial complexes, multifamily housing, shopping centers, hotels, and other types of commercial real estate that help form the backbone of the American economy.

Our principal functions include setting market standards, facilitating the free and open flow of market information, and education at all levels. Securitization is one of the essential processes for the delivery of capital necessary for the health of commercial real estate markets

and broader macro-economic growth. One of our core missions is to foster the efficient, transparent and sustainable operation of CMBS. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to help optimize market standards and regulations.

CMBS is a form of financing whereby commercial mortgages are pooled in a trust and informed investors buy bonds based on the income stream of the mortgages. The bonds are tranched into different risk levels that match investor risk/return objectives. By providing access to the public capital markets, CMBS allows banks and other mortgage originators to free up their balance sheets so they can recycle their limited balance sheet capital into new loans. It is efficient and de-concentrates risk that could otherwise overweight the balance sheets of banks as we saw during the Great Recession.

CMBS is about 25% of all commercial real estate lending – about $100 billion per year. It expands the pool of available loan capital beyond what balance sheet lenders (banks and insurance companies) can contribute to meet borrow demand. There is $600 billion of outstanding CMBS debt, $200 billion of which will need to be re-financed in the next two years. Many of the borrowers are in secondary and tertiary markets. CMBS financing may be the only, or at least the most cost effective, financing they can get.

Since 2010, regulators have sought to implement the Dodd Frank mandate of reducing systemic risk in the financial services sector. Several regulatory agencies were tasked with working collaboratively on rules and reaching consensus. With such a daunting task, it is of no surprise that many aspects of the rules apply broadly across asset types and lack specific correlation to the varying characteristics of different asset types and industry sectors, i.e. CMBS. The problem is "One size does not fit all".

To date, CMBS is subject to Regulation AB II, the Volcker Rule, Basel III (HVCRE, Liquidity Coverage Ratio and Risk-Based Capital), and, of course, the Dodd-Frank Risk Retention rule. The sheer number of new rules and their breadth is resulting in a significant retrenchment by banks and illiquidity in the markets. In many cases, the regulatory burden outweighs the prudential benefit.

Also, there is a growing concern that regulation is institutionalizing inefficiencies. Today, CMBS investors are demanding return premiums similar to corporate junk bonds yet property fundamentals are strong. Property owners face the prospect of higher rates on loans, tougher credit and diminished property values as debt issuance slows. Estimates for 2016 issuance have been downgraded from over $100 billion to $70 billion.

The market is becoming fragile – even before half of the planned regulations come into place. Illiquidity and volatility are becoming the norm.

Why is the CMBS market suffering dysfunction? There are many macro external factors disrupting the capital markets. But, it's clear regulation has a role too … and a big one.

Regulators broadly have concluded that securitized loans are more risky than loans kept on balance sheet -- regardless of the underwriting, credit or collateral. The regulatory cost of capital they impose is simply based on the lending platform. This is a flawed premise.

Because of this burden, CMBS is losing institutional capacity. Banks and mortgage originators are leaving, or substantially reducing, their commitment to the market. Once industry capacity is shut down, it takes a long time before this capacity can be re-generated.

Loss of capacity is problematic in the short run and dire in the long run. When we get to a point in the cycle where capital and credit gets scarce -- and we will -- then the loss of CMBS capacity will hit borrowers broad and hard. Additionally, CMBS bond investors typically are

pension funds and insurance companies. What hurts CMBS also hurts pensioners and life insurance beneficiaries.

A modest but important step Congress can take is the following:

Specifically, we urge Congress to provide modest relief from the Risk Retention rules for one sector of CMBS known as the Single Asset Single Borrower (SASB) market. SASB is a securitization of a single, large mortgage on one asset such as a mall, hotel or office building. Financing for these large, high cost assets is often beyond the scope of one lender. Therefore, it's more efficient to use CMBS financing i.e., the public capital markets.

Investors invest enthusiastically in SASB securitizations because the assets perform extremely well and are easy to analyze and underwrite. SASB is not a multi mortgage conduit transaction. The idea of risk retention was to protect investors buying conduit securitizations where you had dozens of asset in a pool and it was hard for investors to analyze what they were buying. Nevertheless, regulators, with a broad brush, applied risk retention to SASB. This lacks rationale and will do more harm than good.

Not only does this add cost to borrowers and reduce yield to investors, it is expected to hamper the competitiveness of SASB to the point that capacity leaves the sector.

Representative French Hill is promoting a bill that includes very modest changes to the risk retention rules, including an exemption for the single asset, single borrower CMBS. We fully support this legislation and urge the Committee to do so as well.

Introduction

The legislators and regulators had a daunting mission in restoring the health of the financial services sector following the financial crisis and the Great Recession. Eight years later, we have the benefit of empirical data and anecdotal experience about the very real costs of a

macro economic crisis and also, the costs of regulation. It is now also a generally held view that deceleration in growth is likely to be a longer term feature of the national and global economies.

It is within the context of this growth picture that we must revisit our regulatory regime, and specifically its deleveraging objectives, as well as the assumptions and the math behind them. It is critical to note that the Group of Twenty (G20) first added financial regulation to its agenda in 2009, broadening and enhancing the role that the international regulatory bodies played in determining home country requirements. At that time, goals for reducing leverage in the system were based on trends and observations ending with the deepest points of the mark-to-market losses. At the same time, there was little emphasis on the economic effects of regulation. It still remains a challenge to determine the collective effects and costs of the cumulative regulations aimed at the structured finance marketplace, because the rules are still being written.

While the regulators periodically revisit the deleveraging question in speeches and analyses, the U.S. regulators, in particular, seem unwilling to meaningfully investigate the role that regulation is playing in the fracturing of markets, fund flows and the global slowdown. This frustration was felt by CREFC during the rule writing process. We provided to regulators data supported recommendations for modest modifications to the proposed risk retention rules but found little receptivity. Now, CMBS is dislocating and the effects of regulation should be addressed.

While much of the volatility in the current market is the result of geopolitical and other forces, the strong contingent of CREFC's members believe that regulatory burden is responsible for reducing liquidity in and weakening the resilience of our market. Many believe that liquidity is the CMBS linchpin and that the regulations are causing permanent damage to it. Yet, even buy-and-hold investors, such as the pension fund universe (that is reportedly 6.99% invested in

real estate)[1] need market liquidity in order to be able to meet their own regulatory and fiduciary requirements.

CREFC and its members believe that thoughtful regulation can be a net positive and that some new requirements have improved the marketplace. Within the context of the global slowdown and the observable causality between certain regulatory impediments and market dislocations, CREFC believes deleveraging goals and the implementation of certain regulatory requirements should be reexamined.

A significant driver of this deterioration in the CMBS market is regulation. While the broad intent of the regulations is well-founded, the overwhelming burden of rules that lack tailoring to the characteristics of different asset classes provides little marginal prudential improvement, if at all. At the same time, these rules generate significant costs to the end users (i.e., borrowers and consumers) and to savers whose investments are devalued as a result. Consequently, there is a growing chorus of urgent concerns from all ends of the industry that regulation is institutionalizing inefficiencies and could even severely disable the CMBS market. Moreover, lenders and investors agree that a dislocation in CMBS will travel quickly throughout the commercial real estate ("CRE") debt and equity markets, impacting valuations and fundamentals and potentially inciting a negative feedback loop throughout the sector by depressing values and increasing defaults. Certain aspects of the marketplace are so fragile today -- even before half of the planned regulations come into place -- that CMBS is experiencing severe pricing volatility, a marked contraction in issuance and reduction in capacity. We are working on borrowed time to investigate the solution and to initiate remediation.

[1] According to a recent survey, U.S. institutional tax-exempt exposure to real estate debt and equity grew to $835 billion. One of the largest Asset Managers, TIAA-CREF, has $82 billion, or 9.4%, in exposure of a total of $866 billion in AUM as of 3/31/2015. http://www.pionline.com/article/20141027/PRINT/310279999/real-estate-managers-back-over-1-trillion-again

CMBS the Asset Class and Historical Performance

The securitization of commercial mortgages began out of the necessity to clean up the balance sheets of taxpayer-backed depository institutions in the late 80's and early 90's. A combination of excess development in the wake of strong commercial property demand, a subsequent economic downturn, tax reform, and loose credit from depository institutions led to a drastic overbuilding of office properties. By 1989, 534 depository institutions became insolvent due to imprudent loans. Congress created the Resolution Trust Corporation (RTC) in 1989 to dispose of the failed institutions' bad loans. The RTC pooled the mortgages and sold them off as diversified bonds, creating the first CMBS issuances. Since then, the market has become much more transparent and investor-centric.[2]

Credit retracted nationally across industries. Not only had the universe of lenders shrunk dramatically, but the few banks that could lend on property were reluctant to do so, prompting innovative financiers to bypass the banking system for the capital markets. They pooled commercial loans and sold bonds tied to those loans to sophisticated institutional investors from pension funds and insurance companies. By 1998, issuance topped $50 billion per year, and by 2007, issuance topped $200 billion per year.[3]

One of the attractive features of CMBS was that institutional investors (entities with monthly, quarterly or actuarially-driven cash flow obligations) could achieve greater diversification across geography and asset class than by purchasing or originating whole loans themselves. Instead of owning a $50 million loan on a *single* property, the investor could purchase $50 million worth of bonds equally diversified on a pro-rata basis across 40-100 loans

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[2]Alan C. Garner, "Is Commercial Real Estate Reliving the 1980s and Early 1990s," https://www.kansascityfed.org/publicat/econrev/pdf/3q08garner.pdf (2008)
[3] Sam Chandan, "The Past, Present, and Future of CMBS," http://realestate.wharton.upenn.edu/research/papers/full/730.pdf (2012)

in 10-30 individual markets. And importantly, the investor could decide how much risk they wanted to take based on a bond's seniority in the capital structure and the duration of the security. The most secure bonds received cash flow payments first, while the riskiest bonds last. In the event of a distressed sale, bond holders are paid before the borrower who contributed the equity. Typically, these securities offer more yield, transparency and diversification than similarly-rated corporate bonds.

At the asset level, an investor, generally a business entity (a partnership or corporation) – seeks to purchase a commercial property and obtain debt financing on that property. Each commercial property can be thought of as a self-contained business with an income statement and balance sheet. The rents charged to use a property – including monthly apartment, office, or retail rents – serve as the "sales" or revenue for the business.

Similarly, a property has expenses in the form of third-party property management fees (landscaping, maintenance, etc.), property taxes, insurance, leasing expenses (as in the case of an apartment leasing manager, or a retail leasing agent, who go and find renters for the property), and non-capitalized annual repairs to the property. These expenses subtracted from total revenues represent the property's profit and loss, or "P&L". It is through this number that all applicable underwriting calculations, such as debt service coverage ratio ("DSCR"), whether from the investor or lender, are calculated.

The property owner's ability to pay off debt is not measured (since all CMBS loans are non-recourse) – but rather, the *property's*, or business's ability to service monthly payments is measured. A mid- to long-term holder of commercial property, regardless of property type, buys a building based on how much cash flow, or yield, the asset will generate each year, and considers hundreds of data points (ongoing surveillance of CMBS is reported on a monthly basis

via the CREFC Investor Reporting Package, or "IRP" which contains more than 800 data points as well as supplemental reports)[4], in addition to a business plan that includes market information ranging from demographics, supply and demand factors for the asset type, and relative positioning to comparable products.

Post-financial-crisis (also known as "CMBS 2.0"), there are two distinct CMBS markets: the conduit market and the single-asset single-borrower market.

The conduit market pools commercial mortgages ranging in size from $2 million to over $100 million (but generally not more than $100 to $300 million). These loans are stabilized, cash-flowing properties with three years of operating history and professional ownership. As thousands of small banks either closed their doors or were purchased by larger firms in the wake of the 2008 credit crisis, conduits remain a substantial source of debt for secondary and tertiary market real estate operators. Conduit financing provides capital for grocery-store shopping centers, strip malls, family owned hotels, shopping malls, and apartment buildings.

The other type of CMBS lending is single asset/single borrower SASB loans. These loans typically are over $250 million and are made on a single, large property or portfolio of properties owned by one borrower such as large, well-capitalized, public and private real estate companies. Last year, SASB made up over one-third of the total CMBS market, up from roughly 10% historically. Institutional investors enthusiastically invest in SASB bonds. The demand for this market came about as banks and insurance companies were unable or unwilling to offer their balance sheets to finance trophy buildings or portfolios of properties. The credit characteristics of these loans are highly desirable – often many times oversubscribed by investors. Due to the durable nature of commercial real estate's cash flow, and subsequently the

[4] For information on the IRP, please visit: http://www.crefc.org/irp or see Appendix A. This information anticipated by almost 20 years asset-level information now required by the SEC for other asset classes.

CMBS bonds, the asset class as a whole has performed extremely well. The all-time cumulative loss rate for SASB transactions is 0.25%, and 2.79% for conduit transactions.[5]

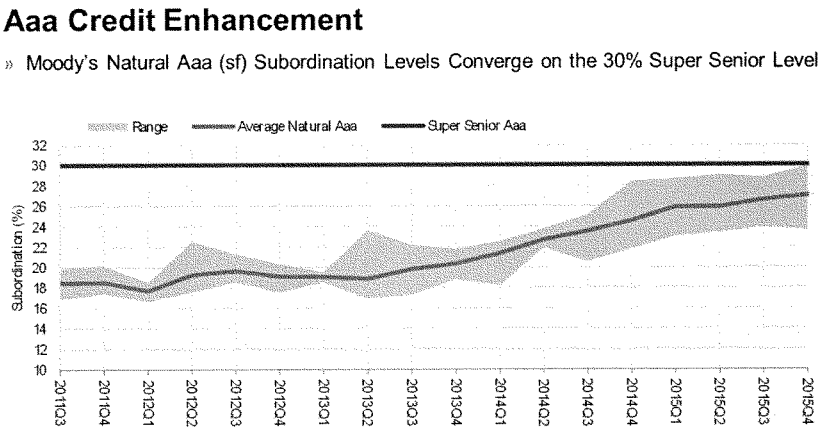
SASB transactions performed better in the depths of the crisis than most fixed income markets perform under *efficient* market conditions. Due to the structure and transparency of SASB deals, investors were (and still are) able to make informed decisions. Addressing the risk retention rule's treatment of SASB transactions is an important recommendation moving forward. The idea of risk retention was to protect investors buying conduit securitizations with as many as 300 assets in a pool. Nevertheless, regulators, with a broad brush, applied risk retention to SASB. This lacks rationale and will do more harm than good. CREFC discussed these issues at length with the Agencies responsible for crafting the risk retention, and our list of submissions to the regulators can be found in Appendix B.[6]

Difference between CMBS 1.0 and 2.0 / 3.0

The CMBS market has greatly evolved in several critical ways since the crisis: 1) pro-forma (aspirational) underwriting is fairly rare and is certainly no longer the norm; 2) CMBS deals include much greater levels of subordination, or cushion, to absorb potential losses (see Exhibit 1 below); 3) collateralized debt obligations (CDOs) backed by CMBS are no longer

[5] As of 08/31/2013, per CREFC's comment letter to regulators.
[6] See CREFC's Letter to various regulators on Risk Retention: http://docs.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/Risk%20Retention%20Proposed%20Rule%20Comment%20Letter.pdf

issued; and, 4) even greater transparency and information is provided to investors.



Source: Moody's Investors Services

Even though the recent economic conditions were primed to result in a return of aggressive lending and funding in recent years, the levels of loan and deal level leverage remained much lower than in CMBS 1.0. Importantly, the double leverage that came with CDO funding, seems to be completely wrung out of the system.

Early regulatory and industry intervention at the beginning of the crisis was successful at weeding out the most ambitious lending and financing forms from the CMBS industry. The combination of accounting changes and additional requirements of the rating agencies as well as other rules helped to stabilize the CMBS market starting in 2010.

CREFC members also played a vital role in this stabilization, as our community contributed a critical new feature of the CMBS 2.0 marketplace - additional transparency

measures in the form of the Annex A, the deal package; and an Investor Reporting Package ("IRP"), a monthly report with over 800 data fields and supplemental reports providing insight into asset, loan, and bond level performance, as well as the final disposition of specially-serviced CMBS loans (See Appendix A for more details on CREFC IRP). CREFC and the CMBS industry have self-regulated over the years as investors demanded standardized deal documents and up-to-date performance data.[7]

In 2009, CMBS issuance had collapsed to almost $0 from a height of $231 billion in 2007. Issuance rebounded to roughly $100 billion in the private label market last year. Until recently, many bonds had excess bidders and the CMBS enjoyed inflows of capital correspondent with performance. It seemed that despite low interest rates, market participants generally agreed that CMBS was functioning well in the main.

As a result, CMBS 2.0 has continued to evolve. More stringent accounting and rating agency rules resulted in greatly reduced economic incentives in CDOs. Now that CMBS are not re-leveraged through CDOs, the dollar value of investable capital is lower today than it was when rates were higher. In addition, the rating agencies have all significantly revised their models and required much greater amounts of subordination. In other words, the bonds at the bottom of the stack that absorb losses have roughly doubled. Thirdly, better transparency in the form of Annex A and the IRP, now in its 8th version, has reinforced better underwriting standards and more extensive due diligence. While the market is constantly evolving, CREFC believes that these positive conditions are not temporary, but rather more permanent features of the CMBS 2.0 and 3.0 markets.

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[7] A full list of these self-regulatory measures is available in CREFC's letter to the Federal Reserve System, the FDIC, Treasury, the SEC, and the OCC: http://docs.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/Risk%20Retention%20Proposed%20Rule%20Comment%20Letter.pdf

Moving Past Equilibrium with the Regulatory Regime to Burden

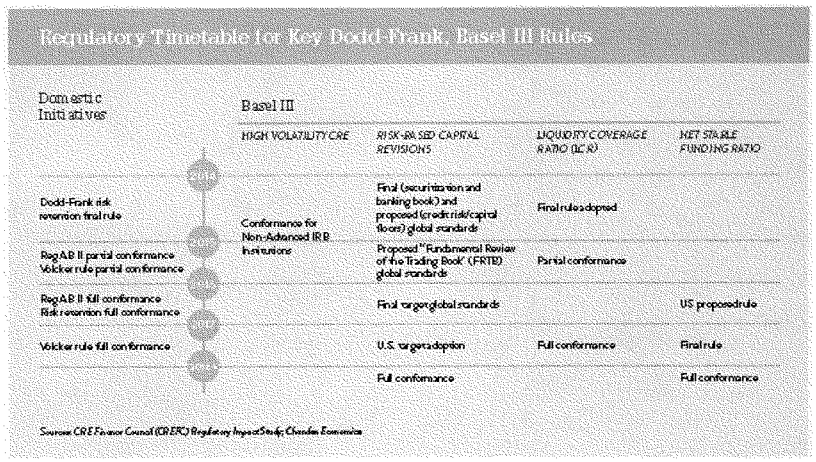
The CREFC community is generally supportive of prudent regulation that appropriately weighs the cost of the regulation with the corresponding prudential benefit it is expected to achieve. In our comments to the various regulators, including the Securities and Exchange Commission ("SEC"), we made this fact known and expressed a desire to work with them in identifying solutions that would enhance positive market practices, including those put in place by the CMBS market itself. Currently, the CMBS market is subject to an extraordinary amount of direct regulation. Further there are innumerable rules that indirectly impact the market by greatly changing the conditions under which the entire financial system operates. These rules then drive the conditions in which CMBS functions. Of the subset of these new rules that affect CMBS most directly, there are:

- the accounting changes FAS 166 / FAS 167;
- rating agency rules;
- Regulation AB II (a set of disclosure requirements);
- reporting requirements to the TRACE facility;
- the Volcker Rule (which sanctions CMBS market making but presents a set of very high hurdles for compliance);
- the Basel III leverage ratio (which affects how market making desks fund themselves with repurchase agreements);
- the liquidity coverage ratio and risk based capital; and
- the risk retention rule (which requires that issuers hold 5% of a securitization).

Last year, CREFC produced a study[8] of the regulatory impacts on the commercial real estate sector overall and found through interviews and quantitative analysis that taken together, regulation has done some good things for our sector, but it has also reconfigured the structure of the markets in such a way that makes it ultimately less resilient in times of stress and also generally runs counter to broader policy goals.

CMBS Liquidity and Market Resiliency

The universal concern of all industry participants is that the constant march of new regulatory requirements will create such a drag on margins that a critical mass of participants will exit. Many CREFC members have commented on this likely end game for CMBS now that they can envision a more complete regulatory timeline.



Starting with the risk retention rule, which goes into effect on December 24 of 2016, borrowers, issuers, and investors are keenly analyzing implementation at this time. CREFC

8 http://www.crefc.org/CREFC/Publications/Regulatory_Impact_Study/CREFC/Resources/Regulatory_Impact_Study.aspx?hkey=47af34d5-3cea-43e1-942f-309fd7508928

gathered estimates last year, and found that the regulation would likely add roughly 10% to the interest rate the borrower pays. This number was calculated assuming stable conditions and *before* CMBS participants started to consider the implementation challenges in earnest. Based on a sampling of issuers and investors more recently, CREFC found that on average, our members believe that much of the current spread widening is driven by regulatory burden, suggesting that the 10% of marginal costs originally estimated will prove to be lower than the actual costs incurred in a volatile trading environment such as the one prevailing for some time now. Given that risk retention is the next piece of regulation to move into effect for our sector, it can reasonably be credited as the greatest driver of costs to the borrower at this time and one of our industry's priorities.

CREFC and its members have consistently supported differentiated treatment for SASB bonds, because the asset class has performed better than most other fixed income sectors, and in some ways, is simply the best performing sector ever through a crisis. Yet, the six regulators that were obligated to promulgate rules related to asset-backed securities, chose to include SASB deals in the coverage universe, even though there was very little, if anything, more that regulation could accomplish with the sector. This rule that was written with conduit structures in mind, will be applied to the SASB universe, despite the fact that the requirements cannot be adopted without wholesale restructuring the SASB model and the market with it.

Additionally, it is important to note that risk based capital rules and the liquidity coverage ratio are steep for our sector, and, more importantly, they treat CMBS relatively poorly compared to other financial instruments. Additional rounds of Basel capital requirements will make CMBS even less viable. Based on a series of interviews conducted with market leaders since the beginning of 2016, the Fundamental Review of the Trading Book (FRTB), which

changes capital requirements for all inventories kept for market making purposes, has been cited as one of the most concerning pieces of regulation, if not the most. Even though the Basel Committee on Banking Supervision (BCBS), reduced the magnitude of the charges applied to CMBS in the final version of the FRTB published on January 14, of this year, these requirements place commercial real estate backed-deals on par with subprime residential mortgages. In turn, it will be even more challenging to allocate capital to CMBS businesses, and ensures continued reduction in secondary market liquidity below even today's levels.

The Liquidity Coverage Ratio (LCR), which is the first of two new liquidity requirements under Basel III, is also an example of regulatory extremism. Again, CMBS is treated the same as residential mortgage-backed securities, despite considerable differences in transparency levels, investor base, systemic risk profile, and many other features. The LCR delivers an unexpected punch to CMBS by requiring that issuing banks reserve liquid assets against the CRE loans they no longer own, considering that issuing banks in no way benefit from or are obligated to support these bonds.

Regulation and Liquidity

In short, these regulations are and will continue to have a significant impact on CMBS. The precipitous decline in CMBS liquidity, especially the prolonged spikes in bid-ask spreads, are particularly troubling and suggest that the market is trading inefficiently in anticipation of the next round of regulation. Moreover, certain trends suggest that the pattern may be sustained for some time, if not deepened:

1) Participants are quickly leaving the market:
    a. The number of market making platforms is declining rapidly, especially those that provide balance sheet and that can hold inventories. One member investor

speculated that there were ten true dealers with capacity to hold inventories and to make markets across a range of new issues last year; that number was halved by year-end 2015 and as of this writing, the number is now down to two or three. The results of the CREFC liquidity survey are aligned with this member's point of view.

b. As expected, the investors who relied on liquidity – those who care more about total returns than relative value – have exited *en masse* in lock step with the liquidity providers, leaving a distinct and troublesome gap at the lower end of the bond stack.

c. While there were roughly 40 conduit lenders last year, they too are starting to close their doors.

2) The features of the market have permanently shifted, and remain lower than during the recovery (2011):

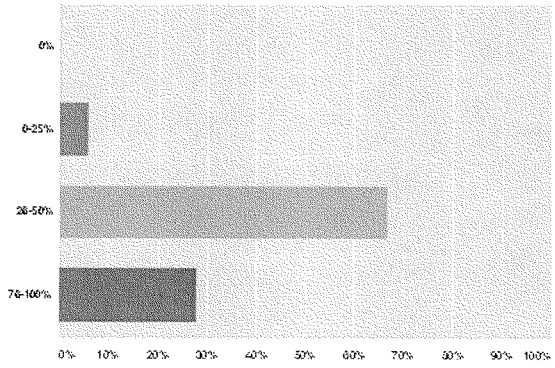
a. Inventories;

b. Turnover; and

c. Trade size.

Investor demand for liquidity relative to market supply is stark. A survey of issuers, traders, investors and other market participants conducted by CREFC in early February suggests that, market-making capacity was already undercapitalized by one quarter to one half. Since then, additional traders have lost their seats, draining further capacity from the system.

Exhibit 3: How Much More Balance Sheet Market Makers Need to Support Secondary Markets



Source: CREFC 2016 Survey on Liquidity

The contraction in secondary market liquidity has been so strong that it has worked its way backwards into the primary issuance market. At the beginning of the year, predictions of $100 billion in private label issuance or more were the norm. By the middle of February, some researchers had ratcheted their forecasts down by roughly one third to as low as $70 billion. This downshifting is extreme for such a short period of time and underlines the significance of the liquidity contraction.

Primary Sources of Overregulation

There are many sources of overregulation, but for the purposes of this document, CREFC will cite one: deleveraging targets. As noted above, the regulators keep track of bank and nonbank leverage in the system globally. Under the auspices of the G20 framework and the many international committees established to set requirements (see Appendix F), regulators are developing an ongoing stream of requirements that continue to address the highest goal, which is

reducing risk in the system. The most noticeable way they do this is to drive credit creation lower.

Despite global growth challenges, the regulatory community remains committed to reducing bank and nonbank leverage, and is especially interested in constraining the structured products sector, especially CMBS. The focus on CMBS has been expressed in multiple ways since the beginning of the crisis. Most importantly, the regulators are working to raise the costs of CMBS and other structured products relative to other asset classes through the risk-based capital and liquidity regimes that tax securitizations more than other products.

CREFC and other industry participants have repeatedly requested that regulators share information about their methodologies, and particularly, their calibration goals, though they keep this aspect of their work secret, generally. The differential in treatment between CMBS and other products is so great, that the regulators seem to be intentionally calibrating to a target that is more. As a result, the CMBS sector is at a greater risk of losing more capacity than any other asset class.

As a consequence, CMBS capacity will leave the market and borrowers will struggle to find credit. In the end, markets will be made unnecessarily inefficient and savers will see their investments devalued more than would have been the case without regulation.

Recommendations and Conclusions

Considering all of the perverse impacts of regulations – both individually and in the aggregate – our list of recommendations would be long, and mostly within the regulatory purview. As such, we began this process first by petitioning the regulatory community for correction and clarification. Regulators accepted some of our recommendations but also declined a good number. It is for this reason that we now seek Congressional intervention.

From the legislative perspective, we urge the Committee to favorably act on the discussion document proffered by Mr. Hill of Arkansas regarding risk retention. Though the ask is modest relative to the regulatory inefficiencies and perverse outcomes faced by CMBS - the recommendations are most meaningful.

Consider and Report Out of Committee Representative French Hill's Risk Retention Discussion Draft.

CREFC strongly supports the recommendations below, which restore the proper balance between protective measures and a healthy, functioning CMBS market for the borrowers and employers in every Congressional district. Specifically, the recommendations would: (1) exempt from the risk retention requirements the highly-sought SASB transactions; (2) set reasonable parameters for regulating and designating as "qualified" certain high-quality commercial loans under the risk retention rules; and (3) provide flexibility in structuring the retained interest to suit investors.

First, the recommendations would address the issues related to the transparent and high-performing SASB transactions by making them exempt from the risk retention requirements. As mentioned above, SASB transactions are marked by superior performance — the SASB segment booked a mere 0.25 basis points in cumulative losses between 1997 and 2013. This financing option is ideal for borrowers seeking to finance apartment complexes, hotels, office buildings, and, of course, gateway market "trophy" properties. Current regulations, which do not include an exemption for SASB transactions, threaten to raise borrowing costs, decrease borrower choice in this market, and induce them to seek other modes of financing that may be less transparent and low risk (e.g., corporate bond markets).

Second, the recommendations would put in place common-sense parameters for considering which CRE loans would be deemed "qualified" under the risk retention requirements. Currently, only a small percentage of CMBS loans would be considered as Qualifying Commercial Real Estate Loans, or QCRE Loans. As background, Dodd-Frank gave regulators the discretion to provide exemptions from the risk retention rules for conservatively underwritten loans, similar to the designation of the QRM standard for residential mortgages. These loans, which meet a set of parameters set by regulators, would be considered "qualifying" loans and exempt from the risk retention requirements. Regulators exercised that discretion in crafting the final rules. Surprisingly, private label residential mortgage-backed securities were given a generous set of qualifying requirements under the QRM standard; in fact, it is estimated that considerably more than 85% of today's RMBS loans would qualify for an exemption. Yet, conversely, in the CMBS space, the qualifying conditions are so onerous that only 3%-8% of all CMBS loans written since 1997 would qualify for an exemption. This has little sense of proportion or compelling rationale.

Mr. Hill's draft would moderately widen the underwriting requirements for QCRE, thus helping maintain credit quality in this space, along with stable pricing and availability of financing for a broad swath of business owners. Specifically, Mr. Hill's draft would allow pools of unrelated/unaffiliated, or "conduit" loans will be allowed to amortize over not more than 30 years (from the current 25-year standard); permit low-LTV interest-only loans to be treated as "qualified" where no authority was granted previously; and permit loans less than 10 years in term as qualifying for exemption under the QCRE rule.

Third, under the risk retention rules, there are special rules for CMBS that allow a third-party investor to purchase the B-piece (known under the rule as the eligible horizontal residual

interest, or "EHRI"). The risk retention rule allows up to two third-party investors to share the 5% retention burden, but requires them to hold their positions pari *passu* (i.e., horizontally). The proposed legislation supported by CREFC would allow third-party purchasers to share the retention obligation *pari passu* or in a senior-subordinate (i.e., vertical) structure. Congressman Hill's proposal does nothing at all to change the core retention requirement or any of the other requirements surrounding the B-piece investors. The core 5% retention requirement and all other general requirements (e.g., substantive due diligence, holding the interest for five years, etc.) would remain intact. The legislation allows for a reasonable amount of flexibility in how the B-piece is held internally by two purchasers. This flexibility will allow the B-piece buyer to match investor capital with the additional capital investment (the retained risk amount) that the rules require. For CMBS, the required amount of risk retained will be about two times that of what is currently invested by B-piece buyers in a typical CMBS deal. That is a massive amount of incremental capital B-piece buyers have to raise in order to be risk retention compliant. And that investment is essentially non-transferable – meaning that the funds raised will be "parked" in a single deal for at least five year. Obviously, this comes with an illiquidity premium that investors will seek – further increasing costs to borrowers. The senior-sub structure will be used to help align investors with this new retained risk requirement. It will not affect at all the amount of risk that must be retained, the underwriting due diligence required by the rules or the holding period requirements of the rules. It simply gives the industry flexibility to achieve the risk retention goals of the regulations.

Additional Recommendations

Additionally, CREFC recommends that Congress consider requiring additional oversight to the regulatory process. This will improve communications between regulators and the industry at all points in the cycle. In specific, CREFC recommends that Congress require:

1. Regulators to outline and operationalize a defined means to secure implementation interpretations of regulation and to formalize a process for filing petitions for "no action" letters from the Agencies when confusion on rule implementation impedes capital flows;
2. That the regulators secure Congressional approval for requirements developed through international forums (for example, FRTB was finalized by the BCBS and regulators should be very vigilant to discern the potential negative impacts such rules could have on market liquidity when undertaking the U.S. rule promulgation process); and
3. That the regulators establish a standing emergency outreach group as a forum in which market participants can air concerns about market functionality and potential dislocations outside of the supervisory silo and without triggering supervisory action.

Conclusion

CREFC would like to thank the members of this Subcommittee for providing the opportunity to submit this statement. CREFC asks that the Subcommittee give serious consideration to the negative consequences of the latest round of rulemaking – consequences far beyond the CMBS markets. More to the point: without a robust and competitive CMBS marketplace our members anticipate a liquidity-driven stress event that could potentially take years to rebalance as market participants leave the arena for other lines of business. This imbalance will have far-reaching and profound effects on communities in a very visible way, by

constricting the funding for commercial properties that we all come to rely on daily for our groceries, housing, workplaces, healthcare, education, and goods and services. In short, the $200 billion of maturing CMBS debt in the next two years will need to be financed regardless of the actions Congress takes. In the absence of intervention and continuity of a competitive CMBS marketplace, we fear that buildings currently funded could fall into foreclosure, resulting in blighted, perhaps empty structures and loss of principal for America's pension and other investors and retirees.

We remain optimistic that there is time to correct this looming liquidity crunch, and we are eager to work with members of the Committee, and with Congress, to ensure that the discretely tailored recommendations embodied in Mr. Hill's discussion draft become law.

Appendix A: CRE Finance Council Investor Reporting Package

The key items of interest included in the CRE Finance Council Investor Reporting Package (IRP) include the following data and supplemental reports that are filed monthly or on an as needed basis.

- Master Servicer Files
  - Loan Setup
  - Loan Periodic Update
  - Property Files
  - Financial Files
- Property Income Statements (Borrowers and Property)
- Special Servicer Loan File
- Special Servicer Property File
- Schedule AL File (Required by SEC)
- Trustee Data Files
  - Bond Level Summary
  - Collateral Summary
- Supplemental Data Reports to be filled out by Servicers
  - Servicer Watchlist/Portfolio Review Guidelines
  - Delinquent Loan Status Report
  - REO Status Report
  - Comparative Financial Status Report
  - Historical Loan Modification/Forbearance and Corrected Mortgage Loan Report
  - Loan Level Reserve/LOC Report
  - Total Loan Report
  - Advance Recovery Report
- Supplemental information to be supplied by Servicers:
  - Appraisal Reductions
  - Servicer Realized Losses
  - Reconciliation of Funds
  - Historical Liquidation Losses
  - Interest Shortfall Reconciliations
  - Significant Insurance Event Report
  - Loan Modifications
  - Loan Liquidations
  - REO Liquidations
  - 1099 A/C Tax Forms for Servicers

Appendix B: CREFC and Industry Background

Industry-led Reforms

Since the crisis, CMBS market participants have sought to address industry weaknesses. A broad variety of stakeholders have taken steps to promote greater levels of discipline in loan origination, structuring, monitoring, and disclosure.

As part of its core mission, CRE Finance Council works closely with its members, including the majority of CMBS issuers, B-piece buyers and servicers, as well as leading investors in the asset class, to establish best practices. In response to the crisis, CRE Finance Council members developed and enhanced several sets of documentation and practice standards, which materially add to market transparency, standardization and efficiency.

The below templates and standards were developed by working groups under the auspices of the CRE Finance Council and staffed by volunteers from the CRE lending, investing and servicing communities. These resources are reviewed and refreshed ongoing, so as to remain relevant and meaningful.

1. ***CREFC Investor Reporting Package (U.S. and EU Versions):*** Standardized and comprehensive package of bond, loan and property level information used extensively in the CMBS marketplace. This data is collected prior to issuance and throughout the life of the transaction.
    a. ***CREFC Special Servicing Disclosure Reports added to IRP™:*** New disclosure reports adopted December 2012 providing increased transparency surrounding special servicer activities, including information regarding affiliates, fees, loan modification decisions, and the final disposition of specially-serviced CMBS loans.
    b. ***Standardized Annex A:*** Provides a deep data dive on the largest loans within the transaction, including enhanced granularity regarding operating statements and additional data with respect to escrow accounts and reserves.
2. ***Pooling and Servicing Agreement (PSA):*** First offered to the public by CREFC's predecessor, Commercial Mortgage Securities Association. Since the crisis, numerous enhancements and modifications have been made, including more specific deal terms and conflict resolution standards for issues involving servicers.
3. ***Model Representations & Warranties:*** Standardized set of representations and warranties for inclusion in transaction documentation regarding the accuracy of loans in the pool, including more than 50 parameters. This is a critical feature of CMBS documentation as it enables investors to pursue loan repurchases in the event of material breaches; representations and warranties essentially function as a loan-level form of "skin-in-the-game" for the originators, issuers and sponsors.
4. ***Principles-Based CRE Loan Underwriting Framework:*** Set of principles establishing industry best practices in underwriting processes and characteristics, encouraging standardization and lower risk-taking in lending.

Appendix C: Links to CREFC Comment Letters and Submissions

Risk Retention

- June 19, 2014: Follow-up to Meeting at the Board of Governors of the Federal Reserve System
- February 28, 2014: Submission to the Agencies regarding risk retention and treatment of SASB & QCRE
- October 30, 2013: Joint Trade Association comment letter regarding the risk retention proposed rule
- October 30, 2013: CREFC comment letter regarding the risk retention proposed rule
- July 18, 2011: CREFC comment letter regarding the original risk retention proposed rule

Reg AB II

- March 28, 2014: CREFC comment letter regarding asset-backed securities
- October 4, 2011: CREFC comment letter regarding asset-backed securities
- August 2, 2010: CREFC comment letter regarding asset-backed securities

Basel Capital Requirements

- March 27, 2015: Joint trades comment letter regarding capital floors
- August 12, 2014: Joint trades comment letter regarding treatment of securirization
- July 25, 2014: CREFC response to BCBS – IOSCO survey on treatment of securitization
- March 24, 2014: Joint trades comment letter on securitization framework

Basel Liquidity Requirements

- March 13, 2014: CREFC comment letter regarding the liquidity coverage ratio

Volcker Rule

- February 13, 2012: CREFC comment letter regarding the Volcker Rule

Appendix D: Timetable for Regulatory Implementation

Rule	Impacted Sector	Concern	Effect	Secondary Effect	Regulator	Status	Fully Effective
Supplementary Leverage Ratio (SLR)	Banks	Risk weightings do not fully capture the risk of a bank	Banks less leveraged	Higher prices/spreads for repo	Fed, FDIC, OCC	Final rule released	January 1, 2018
Liquidity Coverage Ratio (LCR) / High Quality Liquid Assets (HQLA)	Banks, Shadow banking	Banks during the financial crisis did not have enough liquid assets to weather prolonged periods of stress	More difficult for banks to hold non-liquid assets	Higher spreads/less liquidity for RMBS, CMBS	Fed, FDIC, OCC	Final rule released	January 1, 2017
Net Stable Funding Ratio	Banks, Shadow banking	Mismatch between duration of assets and liabilities	Banks punished for liquidity mismatch	Reduction in repo funding	Fed	Not yet proposed	January, 2018 (est.)
CCAR	Banks	Banks and regulators did not have a prospective look at impact of adverse economic scenarios/banks overly aggressive with capital management	Conservative capital management; trapped capital	Reduced lending to marginal credits	Fed	Rule in force	March, 2011
Living Wills	Banks, Nonbank SIFIs	No orderly way to unwind large, interconnected firms	Firms required to plan liquidation	Regulators able to force shedding of business lines, products	Fed, FDIC	Rule in force	December 31, 2013
Intermediate Holding Company (IHC)	Banks	U.S. subsidiaries of foreign banks are undercapitalized for their potential risk, allowing for a regulatory arbitrage with U.S. banks	U.S. subsidiaries of foreign banks exiting U.S. market	Fewer counterparties with repo capacity; less liquidity	Fed	Final rule released	July 1, 2016
G-SIB Capital Surcharge	Banks	The largest banks are so large and systemically important a global scale, they need another layer of capital	Largest banks forced to hold more capital, especially if they use short term funding	Market share shift to regionals	Fed	Final rule released	January 1, 2019
Total Loss Absorbency Capital (TLAC)	Banks	Banks failed during the financial crisis because they could not raise capital	More longer-term debt issued by banks that can be converted to capital	Increased funding costs for G-SIFIs	Fed	Draft rule proposed	January 1, 2022 (proposed)
Margin Requirements for Short-Term Funding	Shadow banking	Too much risk is being taken in short-term wholesale funding	Increase in non-agency repo cost	Decreased liquidity	Fed	Not yet proposed	2018 (est.)
Volcker Rule	Banks, Insurers	Banks using proprietary information to trade against clients' best interests	Elimination of bank proprietary trading desks	Reduction in secondary liquidity could affect M2M	Fed, FDIC, OCC, SEC, CFTC	Rule in force	July 1, 2015
Risk Retention	CRE mREITs	Securitizers do not have enough "skin in the game" and have not been an effective check on the system	Securitizers must hold share of risk	Higher yields in ABS market; reduced capital in B-piece market	Fed, FDIC, OCC	Final rule released	December 24, 2016
Nonbank SIFI designation	Insurers, asset managers	Certain nonbank financial firms do not have sufficient federal regulation	Designated firms may need to hold more capital	Uneven playing field vs. non-designated firms	FSOC, Fed	Authority effective, capital standards pending	May, 2012
Fundamental Review of the Trading Book	Banks, Shadow banking	VAR models do not accurately reflect risk in trading books	Overhaul of risk measurement	Could prompt selling non-agency inventory; negative M2M impact for mREITs	Basel	Proposed framework released	January, 2018 (targeted)
Guidance on Commercial Real Estate Lending	Banks, CRE mREITs	Possible asset bubble in CRE/low banks taking on too much risk	More scrutiny on banks making CRE loans	Banks less willing to make CRE loans, market shares shift to mREITs	Fed, FDIC, OCC	Document released	December, 2015
Guidance on Leveraged Loans	Banks	Banks taking on too much risk in the loans they provide for buyouts	More scrutiny on banks making leverage loans	Banks less willing to make leveraged loans, lower leveraged buyouts	Fed, FDIC, OCC	Document released	March, 2013
Money Market Fund Reforms	Money market	Fixed NAV provides false assurance that funds will not "break the buck"/concerns about runs when NAV falls below $1	Funds pushed to more liquid collateral	Funds could become repo counterparties	SEC	Final rule released	July, 2016
Liquidity Rules for Asset Managers	Asset Managers	Fund managers will not be able to meet redemptions if there are mass redemptions/reducing confidence in mutual funds/ETFs	Shift funds toward more liquid securities	Increased cost of capital for smaller companies; negative impact on bond funds/ETFs	SEC	Draft rule proposed	2016-2017 (est.)
Derivative Rules for Asset Managers	Asset Managers	Fund managers taking on too much risk/juicing performance with over reliance of derivatives	Derivative limits for funds	Lower returns for funds; decrease in leveraged ETFs	SEC	Draft rule proposed	2016-2017 (est.)
Stress Tests for Asset Managers	Asset Managers	A failure of an asset manager would shake confidence among retirement savers	Potential higher capital standards and limitations on capital management for asset managers	Could lower returns for funds	SEC	Not yet proposed	2017 (est.)
Additional Rules for Asset Managers	Asset Managers	Current regulations of asset managers have not been updated to reflect their risks	Heightened scrutiny on asset managers, potentially limiting business activities	Could lower returns for funds	SEC	Not yet proposed	2018 (est.)
Fiduciary Standard Rule	Insurers, Asset managers	Investment advisors are not acting in the best interest of their clients	Move all brokers to "best interest" standard	Lower profitability for broker/dealers and asset managers; limited buyers for certain assets	SEC	Not yet proposed	TBD
Block Trade TRACE Reporting	Banks/Bond trading, Insurers	More transparency is needed in bond market trading	Block trades must be disclosed within 15 minutes	Reduced liquidity and larger bid/ask spreads on FI products; could impact M2M	FINRA	Rule in force	January, 2015

Source: FBR Research

Appendix E: Relevant Regulations and Impacts

The below explanation of the regulatory regime has been excerpted from the CRE Finance Council regulatory impact study Regulatory Design, Real Outcomes that was published in November 2015.

- The Group of 20 (G20) added financial institution regulation to its agenda in 2009 and designated the Financial Stability Board (FSB) to oversee implementation of extensive remediation that regulators sought in response to the financial crisis.
- In the United States, much of the regulatory agenda is embodied by the Dodd-Frank Act, though policy makers are rolling out additional planks of the G20 agenda outside of Dodd-Frank.
- Much of this regulation applies to the CRE sector, including capital, liquidity, risk retention, Volcker, some asset management requirements, and various reporting and disclosure rules.
- Going forward, there are material changes to come for the CRE sector:
    - Basel III remains a work in progress.
    - Newer elements of the regulatory agenda, especially those extending to the asset management sector and to short-term financing, have not yet been exposed.
    - The question of how regulators will treat systemically important financial institutions (SIFIs) and how that regulation may impact the flow of funds to and within the CRE sector remains a key consideration for the industry.
- While major questions regarding regulatory intent remain to be answered, CRE market participants have observed that questions regarding unintended consequences often arise during the implementation phase. This means that even after a rule is published, the

industry requires a period of dialogue with the regulators to answer outstanding questions of interpretation.

- As the regulatory conformance schedule in the U.S. currently extends into 2019, it is likely that the industry will be absorbing major changes from new rulemaking and implementation into the next decade.

For the CRE bank lending sector, capital and liquidity requirements present the greatest financial challenges of the new rules. For the CMBS sector, the credit risk retention rule is the biggest game changer. As of this writing, Basel III capital and liquidity rules are still evolving, and the credit risk retention (CRR) rule will go into effect late in December 2016. Though the Volcker rule allows CMBS underwriting, it restricts secondary trading to market making. Other meaningful rules, such as Volcker, are in effect or going into effect shortly.

Going forward, the regulators are shifting their focus and plotting course on a number of nonbank fronts. Because much of the crisis can be traced to "liquidity transformation", or the use of short-term debt to fund longer term assets, the regulators have aggressively addressed these activities within the banking sector already, but intend to extend requirements and oversight to bilateral repurchase agreements (i.e., those that occur outside of the banking system) and possibly to other types of short-term financing.

Collectively, the regulators are also in the beginning phases of articulating priorities around the asset management industry as a whole, though the SEC did finalize rules related to the money market mutual funds already in 2014. In addition, SEC commissioners have mentioned consideration of requirements relating broadly to portfolio composition, risk management and stress testing.

Finally, the agencies continue to work slowly through the questions of SIFI designation and treatment. As of this writing, the authorities have decided to pursue regulation of asset management activities instead of designations, though they hold out the possibility of also designating asset managers and subjecting them to prudential requirements. Because the systemically important insurers (SIIs), many of which have been designated already, and the potential asset manager SIFI designees are prominent CRE lenders and investors, the issue is an important one to the sector. Not only can new requirements influence business strategy at these firms, but they can influence activities across the sector indirectly.

SII capital and liquidity treatment has not been proposed here in the U.S. However, for these institutions, rating agency requirements have represented binding requirements, or the outer bound threshold. Until new regulatory rules have been rolled out in the US, it is not clear which regime will present the strictest set of requirements.

Perhaps the most prominent regulatory issue at this time is the matter of market making and liquidity. Many rules affect the willingness of bank dealers to support secondary market trading, including Volcker, risk based capital, the liquidity coverage ratio, the leverage ratio (which impacts the repo market), and others. Over the course of 2014 and 2015 public discourse on the nature of liquidity and the sources of its contraction has moved between regulators, Congress, business leaders, and the press. For CMBS, turnover volume remains lower than during the crisis, suggesting that the market is indeed structurally different since rulemaking. Market participants generally cite requirements around capital and repos as the primary drivers of the dealers' pullback on balance sheet allocation to the business.

What follows below is a brief set of explanations of rules and other regulatory activities:

Credit Risk Retention (CRR)

The CRR rule, which requires that all sponsors (or B-piece buyers) hold 5% of a transaction for at least five years, was adopted at the end of 2014 and becomes effective at the end of 2016. It is alternately called the "eat-your-own-cooking" rule and is intended to achieve better underwriting in CMBS pools. The requirement is expect to add costs of 10 bps to 50 bps under (2015) conditions.

Revisions to Basel III Risk-Based Capital

The Basel Committee on Banking Supervision (BCBS) is actively revising the foundational concepts underlying the risk-based capital framework and will likely produce final versions of several new standards late in 2015 and early in 2016.

Initiatives regarding capital floors, treatment of credit risk (portfolio lending) and securitizations will impact costs across CRE business lines at large- and medium-sized banks in the future. Based on some industry analysis produced in relation to the BCBS document, "Revisions to the securitisation framework", we believe that for commercial asset classes with maturities of five years or more, higher capital requirements are expected for most tranches.

The BCBS is also finishing work on the "Fundamental review of the Trading Book" (FRTB), which applies to all assets held for market making purposes. As of this writing (4Q15), the FRTB work stream is possibly one of the most controversial aspects of rulemaking financial system-wide. On average, the requirements as proposed will more than double capital charges for senior and junior bonds, and will be particularly onerous for CMBS as compared to other asset classes. Based on an informal survey of the dealer community, there is a strong majority view that a material number of dealers would drop out of the market, and early estimates of bid-

ask spread widening range of hundreds of basis points. Importantly, the industry would have to conform to these requirements after other rules enter into effect.

Basel III Liquidity Ratios

Basel III mandates that large banks adhere to two liquidity ratios—the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR was adopted in 2014 and went into effect at the beginning of 2015. Meanwhile, US regulators are expected to propose the NFSR in (2016).

The LCR adds costs to whole loans that have drawdown features, such as construction loans. The rule also disadvantages private-label and some GSE-sponsored CMBS. Where banks had used CMBS to help manage their asset and liability (ALM) exposures (the difference in duration between their assets and their liabilities), the rule excludes the vast majority of CMBS from the High Quality Liquid Asset (HQLA) designation, which is becoming fairly synonymous with banks' ALM portfolios.

Based on the BCBS's final standards regarding the NSFR, it appears that this rule when adopted in the US will likely add operating costs to balance sheet loans.

Volcker Rule

The Volcker Rule is impacting the industry on many levels. While CMBS are generally allowed under the rule, and most CRE whole loans appear not to be subject to the trading restrictions, the Volcker rule will require the support of substantial infrastructure representing an ongoing cost of doing business.

Registration and Disclosure Rules

New shelf registration requirements and Regulation AB II and other reporting requirements will add costs to CMBS. The new shelf registration requirements will add an

estimated $20,000 per transaction, according to a senior partner at a law firm. FINRA reporting requirements are considered to contribute to reduced secondary trading liquidity.

Total Loss Absorbency Capital

The first international level proposal for Total Loss Absorbency Capital (TLAC) was published by the Financial Stability Board (FSB) at the November 2014 G20 Summit. TLAC essentially acts as a capital floor for large banks and would override risk-based capital at the holding company level, requiring that large banks hold 16% to 18% capital and high-quality debt, not including buffers. Based on analysis performed by The Clearing House, the FSB's proposal will require that banks establish a cushion that is 2.6x to 5.2x the historical need for capital in a crisis.

The Federal Reserve adopted a final rule relating to part of the TLAC, which established the capital base according to the leverage requirements (total assets to risk-based capital) at 2x the international standards for global systemically important banks (G-SIBs).

Appendix F: Overview of Regulatory Process – International and Domestic

American financial services policy makers often focus on what is historically considered a Eurocentric regulatory regime headed by the Basel Committee on Banking Supervision (BCBS). After the financial crisis, the banking industry and the media focused on the new capital and liquidity requirements the BCBS passed on to U.S. regulators through Basel III. Indeed, their influence has grown, but the international regulatory infrastructure is much more layered than is widely known and yet, it is also heavily influenced by U.S. policy-making goals.

Today, the BCBS and similar standard setting bodies answer to two supranational groups, the G20 and FSB, which often draw their leadership from the Federal Reserve System (FRS) and other U.S. agencies. Moreover, the other member nations generally view the U.S. as the nation that led the financial crisis, should be first among equals in adopting the regulations that are contributing to structural shifts in the capital markets.

Officials from the FRS, FDIC, OCC, SEC, and other regulatory bodies led the conversation in Basel and abroad and directly contributed to the increase in capital and liquidity standards contained in Basel III and other rules being adopted at home. Think of the G20 and FSB as an executive, decision-making arm that sets the international agenda, while the various Basel committees consult, research, and publish the rules that carry out these international regulatory goals. The entire regulatory architecture synergistically shares the same resources, staff, and officials - mainly those mentioned in the preceding paragraph.

What is the Systemic Risk Agenda? Who are the Macro Prudential Regulators?

In the post-financial crisis era, nations recognized and felt the impact and toxicity of excess financial leverage. Rightfully so, leaders called for a coordinated response effort, and more importantly, a framework to prevent similar crises in the future. The largest nations and

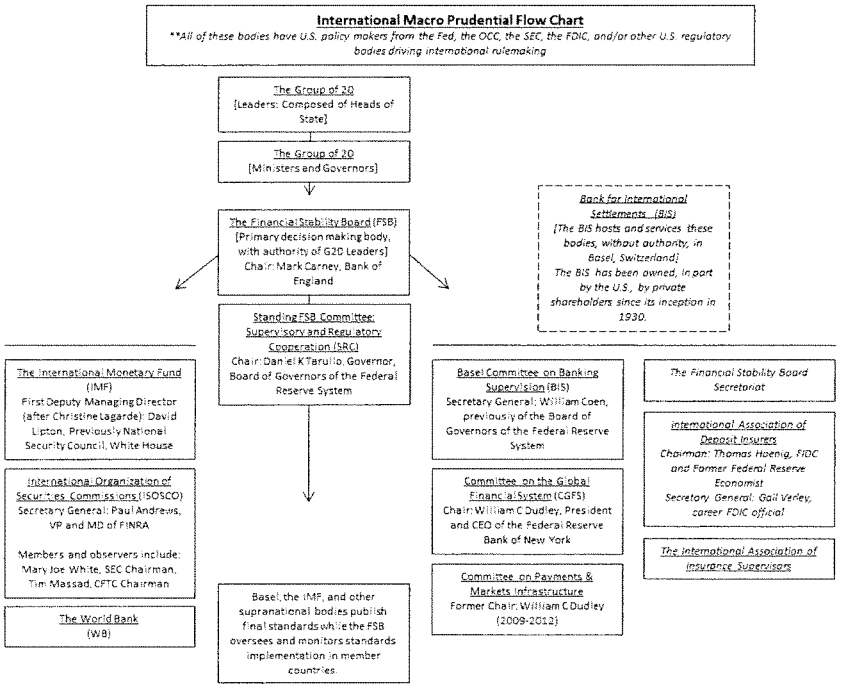
emerging market economies under the leadership of the newly created G20, met to expand existing supranational regulators as well as create new ones. Collectively, these nations set out to weed out systemic risk and promote economic growth and stability.

Since 2009, an aggregation of supranational bodies led by the FSB, with the distinct power granted by the leaders of the G20, leads the international regulatory rulemaking, implementation, and oversight process. Acronymic bodies including the BCBS, International Organization of Securities Commissions (ISOCO), Bank for International Settlements (BIS), Committee on the Global Financial System (CGFS), The World Bank (WB), and the IMF (IMF), all serve various decision-making, research, implementation, and oversight roles within, but underneath, the supervision of the G20 and the FSB.

No single nation is "in charge" and no single body exists to implement policy or regulations from the international level; individual jurisdictions are responsible for tailoring nada adopting requirements through their own legislative and / or rulemaking frameworks. Sovereign nations are responsible for implementing and monitoring their own capital, liquidity, and risk management rules across their banking and financial services industries. With each subsequent international financial crisis, supranational standard setting bodies have emerged with more influence and the ability to create "soft law" in the wake of financial turmoil. It is with this lens that the current international financial regulatory architecture may be viewed.

However, the United States, acting through the Federal Reserve, has considerable authority by way of conducting monetary policy, providing liquidity to central banks during crises, and by extension, commercial banks, abroad. It has the leadership role not just because of the size of its central bank balance sheet and ability to absorb risk, but also due to its supervisory role.

The Federal Reserve and the U.S. banking agencies have leadership posts or influence on every single supranational body this paper outlines – including the G20, the FSB, the Basel Committees, ISOCO, the IMF, and the World Bank.



The Group of 20 (G20)

The G20 is generally considered one of the preeminent organizations on international matters, especially international financial regulation. Self-appointed in 2009, the body expanded upon the G7 to include larger developing economies in order to better account for systemic risk, and includes the 19 member countries plus the European Union (EU). G20 member countries

account for 86% of global GDP, 90% of global banking assets, and 94% of the global bond market.

The G20 is split among two levels: 1) G20 Leaders, made up of heads of state; and 2) G20 Governors, made up of central bankers and treasury officials and their equivalents. The leaders meet on a near-annual basis to review work of the G20 Ministers and set the agenda for the ministers' future work, while ministers execute the Leaders' agenda on an ongoing basis.

Financial Stability Board (FSB)

The FSB is the primary global decision making body, and has been since the G20 created the FSB in 2009 to coordinate international financial regulation.

> "The FSB promotes international financial stability; it does so by coordinating national financial authorities and international standard setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies...the FSB, working through its members, seeks to strengthen financial systems and increase the stability of international financial markets. The policies developed in the pursuit of this agenda are implemented by jurisdictions and national authorities."

The FSB Charter derives its authority from the G20 Leaders' statement explaining that the FSB should be "given a broadened mandate to promote financial stability, and re-established with a stronger institutional basis and enhanced capacity" including responsibilities such as reviewing, coordinating, and addressing gaps among the "international standard setting bodies" (i.e., Basel, etc.) and "oversee action needed" to address financial system vulnerabilities."

The FSB's previous iteration, the Financial Stability Forum, served a consultative function with international standard setting bodies. However, in 2009, the heads of state of the largest economies of the world improved the FSB's mandate to implement the overarching regulatory agenda and ensure implementation of the rules published by international standard setting bodies.

Note that the main influencing bodies of Basel – i.e., sovereign member nations – have not changed, however, the decision making process has. Instead of sovereign nations, mainly the United States, shaping supranational regulatory policy through the Basel Committee, they do so today through the G20 and FSB.

The FSB is chaired by Mark Carney, Governor of the Bank of England. Carney directs the Plenary, a committee of 69 members from FSB member countries, international financial institutions, and international standard setting bodies. Members of the Plenary include representatives from the G20 countries, the World Bank, the IMF, the BIS, the ECB, the European Commission, the BCBS, the IAIS, IOSCO, IASB, CGFS, and the OECD. In essence, the membership of the G20 is circular –its members, who help set the agenda, are also tasked with developing the rules they seek to create.

The Secretariat of the FSB is located in Basel, Switzerland, and is hosted by the Bank for International Settlements. The Secretariat has 33 members and supports the policy development and activities of the FSB. The Secretariat is noted here because of its proximity and closeness to the "Basel Process," explained in the next section. The proximity and location of the FSB in Basel further engenders the close thinking of the economists, central bankers, and regulators that work out of the various committees hosted by the Bank for International Settlements.

The Bank for International Settlements (BIS)

The Bank for International Settlements hosts a number of international standard setting bodies – notably the Basel Committee on Banking Supervision and the Committee on the Global Financial System – that are physically housed at the BIS facilities. In fact, all but IOSCO sit in the Basel location.

The best-known committee, the BCBS, was formed in 1974 by the Group of 10 (G10) in the wake of economic turmoil – the collapse of fixed exchange rates, rising oil prices, interest rate fluctuations, and bank failures. Prior to the creation of the BCBS, the BIS served as an international meeting place and information exchange for central bankers. It became the supranational regulatory body it is today in the early 90's after the Federal Reserve formally joined the Basel Process and the BIS.

BCBS membership includes central banks and regulatory authorities (in the U.S.: FRS, OCC and FDIC); and other international groups including the BIS, the IMF, the Basel Consultative Group (a liaison group to non-members), the European Banking Authority, and the European Commission. "The Basel Process is based on three key features: synergies of co-location, flexibility and openness in the exchange of information, and support of the BIS's expertise in economics, banking, and regulation."

BIS Ownership and Founding

The BIS is a private, for-profit firm. It was created principally as a bank – to take deposits and make loans, while providing trustee and agent services for its central bank clients. It formed in 1930 as a commercial bank with public shares, which were primarily offered to central banks. Eighty-six percent of BIS stock is owned by central banks while 14% is owned privately by public shareholders. Ownership entitles shareholders to dividend payments but only member central banks are entitled to sit on the BIS board or attend board meetings – which are notoriously secretive making its importance and banking services difficult to quantify.

Today, the U.S. sits on the board of BIS and has since 1994 when it quietly joined the organization. In 1930, the Federal Reserve was barred from owning shares or from formal BIS board participation, instead, shares were held in a trust by First National City Bank.

Importantly, the bank's charter and statutes explicitly state that the bank was set up to execute the monetary policy of its member banks. If a member bank disagrees with a financial transaction that the BIS plans to execute, member banks (who collectively own the BIS) have the ability to dissent and stop a transaction.

International Organisation of Securities Commissions (IOSCO)

The International Organisation of Securities Commissions, also known as IOSCO, is the international body that connects the world securities' regulators – in the U.S., the Securities and Exchange Commission. It was established in 1983 and operates out of Madrid, Spain – a notable departure from most of the standard-setting bodies based out of Basel.

The organization's stated purpose is to maintain fair and transparent markets while addressing systemic risks. It is governed by the ISOSCO board, comprised of 33 securities regulators, including Tim Massad, Chair of the CFTC, and Mary Jo White, Chair of the SEC.

The Role of the Federal Reserve during the Financial Crisis

The Federal Open Market Committee (FOMC), acting through the Federal Reserve Bank of New York (FRBNY), is able to conduct currency exchange or swaps. In 2007, the FOMC created temporary dollar liquidity swap lines with 14 central banks, recognizing that the EU, UK, and Swiss banking industries had over $8 trillion in USD exposure. In 2008, temporary swap lines peaked at $583 billion, equaling 25% of the Fed's balance sheet at that time and four times the total outstanding IMF credit (IMF intervention peaked in 2010).

The FRBNY publishes quarterly reports on its foreign exchange activities. Its most recent report, covering Q3 2015, stated that the Federal Reserve Open Market Account Holdings had $20 billion in foreign currency denominated assets, primarily in yen and euro. In October 2013, the central bank made six of those swap lines – the Bank of Canada, the Bank of England, the

Bank of Japan, the European Central Bank, and the Swiss National Bank – permanent, to foster financial stability.

The U.S. Treasury also has the ability to execute foreign exchange through its Exchange Stabilization Fund (ESF). As of December 31, 2015, it holds a total of $118 billion in reserve assets, mainly consisting of $49 billion in Special Drawing Rights (SDR), $11 billion in gold, and $17 billion in "other national central banks, BIS and IMF."

The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations: Testimony before the U.S. House of Representatives Subcommittee on Capital Markets and Government-Sponsored Enterprises

Marcus Stanley
Policy Director
Americans for Financial Reform

Wednesday, February 24, 2016

Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to testify before you here today. My name is Marcus Stanley and I am the Policy Director of Americans for Financial Reform.

The issues of interest to the committee today – underwriting quality in securitization markets, bank activities in trading and securitization markets, leverage in bank trading books, and the effect of regulation of these areas on market liquidity – go to the very heart of the 2008 financial crisis. Indeed, a shorthand description of that crisis might read "irresponsible and fraudulent practices in securitization markets infected the trading books of banks central to the financial system, leading to a catastrophic and extended failure of market liquidity."

For these reasons it is not surprising that the Dodd-Frank Act targeted these areas for increased oversight. It did so in a number of ways, including reforms aimed at securitization markets, limitations on excessive bank borrowing, and a ban on bank proprietary trading.

Now some are calling these reforms into question because of their supposed impacts on market liquidity. We oppose these efforts to roll back post-crisis reforms. It is particularly ironic that they are being advanced in the name of "increasing liquidity". A central lesson of the crisis is that market liquidity can be excessive, and that such excessive liquidity leads to disastrous market crashes that have far more damaging liquidity effects than those that might be created by prudent limits on excessive leverage and risk-taking in normal markets.

Lessons of The Financial Crisis

The financial crisis of 2008 was preceded by a period of excess market liquidity, cheap credit, and falling spreads. Indeed, it was commonplace for observers at the time to speak of a "liquidity glut" or a "wall of liquidity" in the financial markets.[1] Notably, even before the financial crisis there is little evidence that this flood of liquidity increased economic efficiency or productivity. Even as Wall Street profits soared, the period of the liquidity bubble saw relatively low levels of

[1] Rajan, Raghuram, "Investment Restraint, the Liquidity Glut, and Global Imbalances", Remarks by Raghuram G. Rajan, Economic Counselor and Director of Research, International Monetary Fund, At the Conference on Global Imbalances organized by the Bank of Indonesia in Bali November 16th 2006

GDP growth, sub-par levels of business investment, and a massive capital misallocation into residential real estate.[2]

This liquidity bubble fed excessive leverage and risk in the system, eventually leading to a devastating liquidity failure. A clear lesson of this crisis is that excessive liquidity in "normal" markets can lead directly to a liquidity failure in stressed markets. The situation was well summarized by economist Lasse Pederson soon after the crash:

> In the years preceding the crisis, the global financial markets were flush with liquidity due to low interest rates, high savings rates in Asia, economic growth, and low volatility. As a response to low borrowing costs and low apparent risk, financial institutions became highly levered (a positive liquidity spiral). This made them vulnerable. When house prices started to decline and it started to become clear in 2007 that subprime borrowers would default in large numbers, an adverse liquidity spiral was kicked off. [3]

There were many underlying causes of this excessive liquidity and eventual crash. But two of the most central and critical were failures of underwriting and oversight in the securitization markets, and excessive leverage in the trading books of major dealer banks.

In the securitization markets, an "originate to distribute" model lessened incentives of lenders to monitor the quality of their loans and sponsors to monitor the quality of securitizations they produced and sold to third party investors. Credit rating agencies, which investors relied on to assess the quality of these complex and opaque securitized assets, proved to be deeply unreliable and corrupted by inappropriate incentives, particularly in the structured finance area. To take one example, some 20 percent of all investment grade AA-rated structured securities ever rated by Moody's between 1980 and 2010 eventually defaulted.[4] For some securities, failure rates were much higher. Loss rates for the very highest rated and supposedly safest (senior AAA) structured finance collateralized debt obligations ("CDOs") issued in 2006 and 2007 exceeded 75 percent.[5]

Lack of oversight in the securitization market had far-reaching impacts on the financial system, including a dramatic negative effect on the quality of individual loans produced to feed the securitization machine. Another major effect was on the securities holdings of the major dealer banks at the center of the financial system, who played key roles in the securitization markets as sponsors, underwriters, and traders of securitizations. These banks ended up holding hundreds of billions of dollars of securitizations on their balance sheets, positions that were funded overwhelmingly by debt.

These debt-funded holdings were attractive because bank capitalization rules permitted enormous amounts of leverage to be held against bank trading book assets. Trading book capital

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[2] Chinn, Menzie and Jeffry Frieden, Lost Decades: The Making of America's Debt Crisis and The Long Recovery, W.W. Norton, 2011.

[3] Pederson, Lasse, "When Everyone Runs for the Exit," International Journal of Central Banking, International Journal of Central Banking, vol. 5(4), pages 177-199, Dec. 2009.

[4] Cornaggia, Jess and Cornaggia, Kimberly Rodgers and Hund, John, Credit Ratings across Asset Classes: A Long-Term Perspective, 10 Nov. 2015, available at SSRN: http://ssrn.com/abstract=1909091

[5] Cordell, Larry, et al. "Collateral Damage: Sizing and Assessing the Subprime CDO Crisis," 1 Aug. 2011. FRB of Philadelphia Working Paper No. 11-30. Available at SSRN: http://ssrn.com/abstract=1907299

was determined based on the volatility of trading market prices. Thus assets that recent historical experience indicated were highly liquid attracted very low capital charges and could be funded almost entirely through short term borrowing. They were therefore highly profitable. These inadequate capital charges were generally determined using the banks own internal capital models. Such models did not reflect tail risks of extreme outcomes, and banks had every incentive to adjust them to permit higher leverage levels.

In the end, key dealer banks at the center of the financial system were borrowing well over $30 for every dollar of hard capital, and at the same time holding assets that were highly overvalued. The epicenter of the problem was in bank trading books, which had much higher leverage than other banking assets. Trading assets were often funded using $100 or more of borrowed money for every dollar of hard capital.[6]

In sum, the experience of the financial crisis demonstrates that market liquidity can frequently be excessive, that "originate to distribute" markets in complex and opaque financial products such as securitizations are particularly vulnerable to such excessive optimism but will lose liquidity overnight once doubts arise about asset quality, and that liquidity bubbles can support dangerous and excessive levels of borrowing at key financial institutions at the center of the markets.

Three elements of the post-crisis regulatory response targeted these problems:

1) Increased oversight of the securitization markets. This occurred through new "risk retention" requirements that securitization sponsors hold a share of the securities they sold, thus giving them an incentive for better underwriting, and also by increased regulation of credit rating agencies.

2) Increased capital requirements limiting excessive bank borrowing, especially for the major dealer banks. These new requirements set a minimum overall level of permitted leverage for bank balance sheets. Efforts by U.S. and international regulators have especially targeted the inadequate capital held against bank trading assets. Regulatory efforts to ensure proper modeling of bank trading risks are ongoing in the "Fundamental Review of the Trading Book" recently finalized by the Basel Committee.

3) In the U.S., Congress took direct action to restrict bank misuse of the trading book by banning proprietary trading through the Volcker Rule. The Volcker Rule also bans bank ownership of hedge funds, private equity funds, and complex securitizations which are structured as fund-type investment vehicles. These complex securitizations (such as CDOs) saw some of the worst abuses during the financial crisis.

Even today, over seven years after the financial crisis, many of these reforms are not fully implemented. The reform that is most advanced is in the area of bank capital, where regulators have moved rapidly to increase overall bank capital. But they are still working on the details of a

[6] UK Financial Services Authority, "The Turner Review: A Regulatory Response to The Global Banking Crisis", Financial Services Authority, London, England, Mar. 2009. Available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

reformed treatment of bank trading risks. In the area of securitization reform, risk retention requirements were finalized in late 2014 but have not yet been implemented in many areas. Importantly, crucial reforms of credit rating agency oversight, which are essential to making these markets safer, have been significantly weakened and are of questionable effect.[7] Volcker Rule limitations on proprietary trading went into initial effect last summer, but key limits on bank ownership of hedge funds and securitizations have been delayed until 2017, and we have very little insight into how effectively Volcker trading limitations are actually being enforced.[8]

Some Lessons of Market Experience Since The Financial Crisis

Industry lobbyists predicted dire negative impacts of regulatory reforms. For example, in 2010 the Institute for International Finance (IIF) predicted that limits on bank borrowing would lead to massive increases in spreads, collapses in lending levels, and declines of over half a percentage point (approximately 20-25 percent) in economic growth.[9] But these predictions have turned out to be major exaggerations. As economist Stephen Cechetti stated in late 2014:

> Well, the jury is in…Capital requirements have gone up dramatically, and bank capital levels have gone up with them. In the meantime, lending spreads have barely moved, bank interest margins are down, and loan volumes are up. To the extent that more demanding capital regulations had any macroeconomic impact at all, it would appear to have been offset by accommodative monetary policy. [10]

Despite the fact that past prophecies of disaster have not materialized, lobbyists have continued to ascribe an enormous range of negative effects to Dodd-Frank and other regulatory reforms.

Sometimes this has taken the form of ascribing long-term trends that far pre-date the financial crisis and are influenced by many other factors to recent financial regulatory reforms. For example, the decline in the number of small community banks, which has been ongoing since the 1980s, has sometimes been ascribed to the Dodd-Frank Act, despite evidence of the strong post-crisis recovery of the community banking sector after the passage of Dodd-Frank. Just yesterday the FDIC reported that 95.2 percent of all community banks showed annual profits in 2015, up from just 77.8 percent of community banks that showed a profit in 2010, the year Dodd-Frank was passed.[11]

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[7] Morgenson, Gretchen. "Ratings Agencies Still Coming Up Short, Years After Crisis". Nytimes.com. 23 Feb. 2016; Americans for Financial Reform, "Request for Re-Proposal Relating to Nationally Recognized Statistical Rating Organizations," 1 Apr. 2014, available at http://ourfinancialsecurity.org/wp-content/uploads/2014/04/AFR-SEC-Credit-Rating-Agencies-Comment-Letter-4.1.14.pdf.

[8] Americans for Financial Reform, "Letter to Joint Regulators on Transparency of the Volcker Rule," 17 Dec. 2015, available at http://ourfinancialsecurity.org/wp-content/uploads/2015/12/AFR-Volcker-Joint-Letter-12.17.15-1.pdf

[9] Institute of International Finance, *Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework*, Jun. 2010.

[10] Cecchetti, S G, "The Jury is In", CEPR Policy Insight 76, December, 2014. Available at http://www.cepr.org/sites/default/files/policy_insights/PolicyInsight76.pdf.

[11] Federal Deposit Insurance Corporation, "FDIC Quarterly Banking Profile, 4th Quarter 2015", FDIC, Washington DC, 2016. Available at https://fdic.gov/bank/analytical/qbp/2015dec/

The increase in cash holdings by non-financial corporations, which is a long term trend dating from the mid-1990s and appears to be tied to corporate tax rules, changes in technology, and increases in profit volatility, has also been ascribed to financial regulatory reforms, despite the lack of concrete evidence of any tie.[12]

More recently, it has become popular to ascribe changes in patterns of market liquidity to new financial regulations. There is no question that financial markets have evolved and changed since the financial crisis. While many of these changes are linked to the crisis itself, some are also tied to regulatory reforms. Indeed, regulatory reforms are intended to impact market activities and if they did not do so they would be a failure.

However, it is difficult to see evidence that post-reform changes in market liquidity have had a serious impact on the real economy. The changes in market liquidity that can actually be clearly documented appear to be twofold. The first is some increase in the number of brief and temporary liquidity failures ("flash crashes" or "tantrums") in various trading markets, including equities, derivatives, and fixed income. This flash crash issue appears to be tied to the increase in high-speed electronic trading in disintermediated trading markets and not directly to new financial regulations.[13] The second change is a decline in trade size, which implies an increase in the number of trades and the time necessary to dispose of a large block of securities. However, this decline in trade size has so far not led to any clear increase in real investor costs such as a growth in bid-ask spreads or the price impact of trades.[14]

These changes, particularly the decline in trade size, may be partially linked to some post-crisis "disintermediation" of major dealer banks that were the key intermediaries in trading and securitization markets prior to the financial crisis. As discussed above, this intermediary role was enabled by the fact that regulators permitted banks to maintain highly leveraged trading inventories funded overwhelmingly by short-term debt. The post-crisis increase in bank capital requirements means that banks must actually support these inventories with their own capital. This seems to have led banks to lower their securities inventories, possibly resulting in less of an intermediary role in certain markets.

As Figure 1 below shows, after the rollback of Glass-Steagall restrictions in the 1990s banks enormously increased their securities inventories leading into the financial crisis, doubling the proportion of their assets held as private securities (i.e. not backed by the U.S. government). This increase was associated with an increased role as intermediaries in securitization markets. However, these securities inventories have declined significantly since the crisis.

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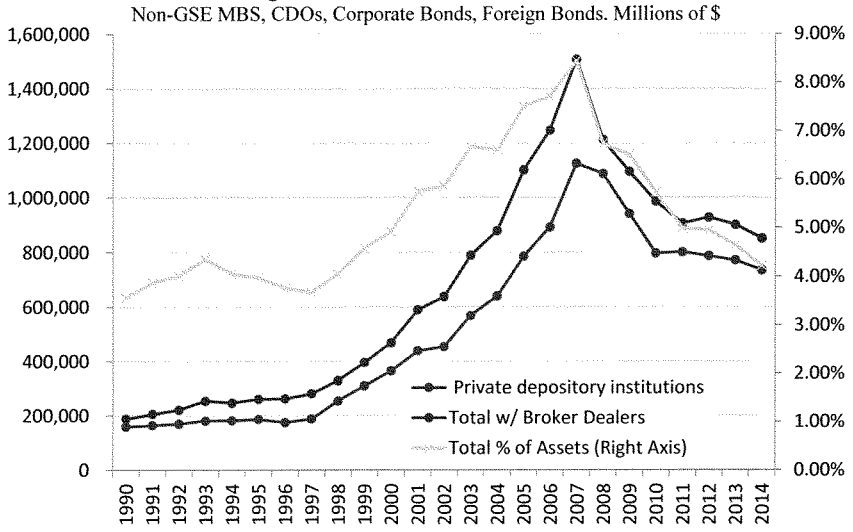
[12] Sanchez, Juan and Emircan Yurdagul, "Why Are U.S. Firms Holding So Much Cash?", Federal Reserve Bank of St. Louis Review, July/August 2013, available at https://research.stlouisfed.org/publications/review/13/07/sanchez.pdf

[13] Commodity Futures Trading Commission and Securities and Exchange Commission, "Findings Regarding the Events of May 6, 2010: Report of the Staffs of the CFTC and SEC", September 30, 2010, available at https://www.sec.gov/news/studies/2010/marketevents-report.pdf ; U.S. Department of the Treasury et. al. "Joint Staff Report: The U.S. Treasury Market on October 15, 2014", July 13, 2015, available at https://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2015.pdf

[14] Adrian, Tobias et al. "Has U.S. Corporate Bond Market Liquidity Deteriorated?" Liberty Street Economics Blog, Federal Reserve Bank of New York, 23 Feb. 2016, http://libertystreeteconomics.newyorkfed.org/2015/10/has-us-corporate-bond-market-liquidity-deteriorated.html#.VsxZ1tBl3IU.

Figure 1: Bank Securities Inventories

Non-GSE MBS, CDOs, Corporate Bonds, Foreign Bonds. Millions of $



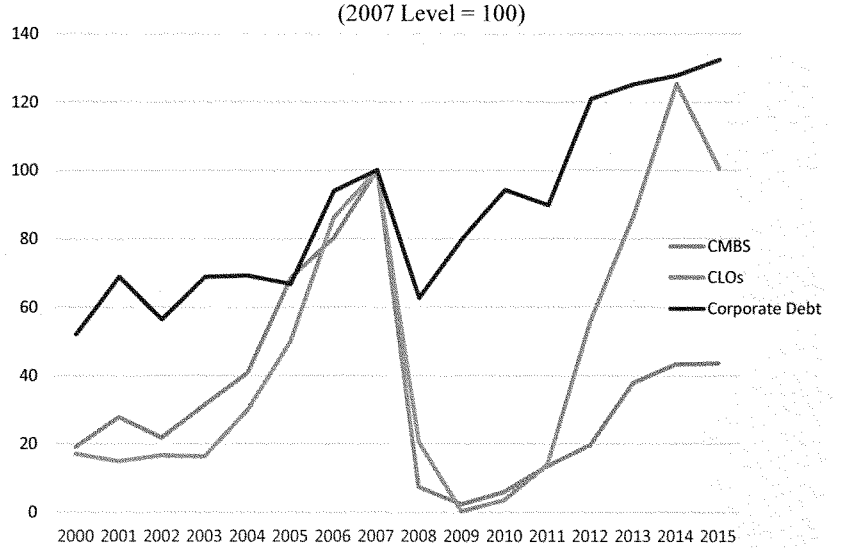
The disintermediation of the major "too big to fail" Wall Street banks, and the decline in their leveraged securities inventories, should be seen as a positive and intended effect of regulatory changes. Especially where inventories were held because returns could be boosted using excessive leverage levels they contributed in a major way to systemic risk, as any decline in trading valuations required massive bank deleveraging and "fire sales" that were highly disruptive to the financial system. The tight linkages between inherently volatile trading markets and major 'too big to fail' banks at the center of the payments system was a profound contributor to financial contagion and the magnitude of the financial crisis.

Changes in bank activities may have led some traders to seek out a more diverse set of non-bank dealers and to move more activities to exchange-based trading markets. This shifts in market structure may call for action to ensure the safety of these exchange-based markets, particularly as regards potential disruptions created by high-speed algorithmic trading. But we should not move backward to the disastrously unstable and overleveraged system that existed prior to the financial crisis. It would be particularly ironic to do so in pursuit of "liquidity", as this system enabled excessive and risky levels of market liquidity prior to the crisis.

It is also important to observe that during the post Dodd-Frank period the fixed income markets have remained very open to real economy companies for the purpose of capital formation. In fact, issuance in some markets has soared. Figure 2 below shows securities issuance trends

before, during, and after the crisis in issuance of corporate debt and two forms of securitization, commercial mortgage backed securities (CMBS) and collateralized loan obligations (CLOs).

Figure 2: Issuance of Securities and Securitizations, 2000-2015
(2007 Level = 100)



SOURCE: SIFMA, Fitch Ratings

This chart shows the run up in issuance prior to the crisis, particularly for CMBS, which was enabled by excessive liquidity and compressed spreads in the market. It also shows that the most devastating impact on these markets clearly occurred due to the crisis itself, which caused them to effectively shut down for a period of years. This is a reminder that the most extreme and damaging costs of market illiquidity occur due to excessive financial risks and the instability that results, not due to prudent controls on financial excesses.

However, since 2010 these markets have seen a pronounced and extended recovery, with issuance of both corporate debt and CLOs significantly exceeding pre-crisis highs. All of this has occurred since the passage of the Dodd-Frank Act. While the issuance increases are likely more related to accommodative monetary policy than to new financial regulations, the implementation of the Dodd-Frank Act certainly does not appear to have been harmful.

Over the last few months, from December 2015 through early 2016 we have of course seen significant disruptions in high yield debt markets, including a large increase in spreads and decline in issuance. These changes are clearly traceable to changes in energy prices, changes in Federal Reserve interest rate policy, and other real economy factors, not to regulatory burden.

The market for higher-quality investment grade fixed income debt has *not* been strongly affected, with issuance in that market exceeding levels from a year ago and valuations remaining healthy. Since changes in market structure and financial regulation could be expected to impact all types of debt, not just high yield debt, this is a strong indication that recent disruptions are related to actual underwriting issues and not to changes in financial regulation.

Recommendations With Respect To Legislation And Regulation

With respect to the legislation under consideration by the Subcommittee today, all three of these bills act to weaken and undermine Dodd-Frank regulatory changes designed to improve oversight of securitization and bank trading book activities. By far the most significant are the two bills that would greatly increase exemptions to new risk retention rules designed to improve incentives in complex securitization markets. (H.R. 4166 on CLOs and the discussion draft on CMBS risk retention). H.R. 4096, addressing certain provisions of the Volcker Rule, would have much less serious effects but still should not be passed in its current form.

Legislative Exemptions to Securitization Risk Retention

Risk retention rules require that sponsors of securitizations retain on their books five percent of the credit risk of securitizations they issue. This aligns incentives in order to encourage better underwriting and design of these securities. Such incentive alignment works against the negative effects of "originate to distribute" models of securitization which permit sponsors to pass on the risk of securities they design on to third parties.

Importantly, regulators have already incorporated significant underwriting-based exemptions to these risk retention requirements. Under the risk retention final rule, securitizations that are limited to loans which meet good underwriting standards, based on the existing leverage of the borrower and income/cash flow/valuation relative to the debt taken on, would be exempt from risk retention requirements.

H.R. 4166 and the CMBS discussion draft would both enormously increase the scope of these exemptions for CLOs and CMBS, effectively eliminating risk retention requirements for loan securitizations that do not meet strict underwriting standards.

For example, the CMBS discussion draft would exempt interest-only loans from risk retention requirements, prohibit regulators from addressing issues with the length of loan amortization schedules, and apparently mandates that regulators could not adjust loan to value caps for commercial loans based on the estimated cash flow from the property. The discussion draft also provides a blanket exemption for all 'single loan' securitizations, broadly defined as securitizations collateralized by a loan or related group of loans on commercial properties that are under common ownership or control. While such securitizations may be somewhat more transparent to investors in some cases, they also lack diversification benefits and certainly may be poorly underwritten, just as any other loans may be.

H.R. 4166 addresses risk retention for CLOs. It would eliminate any restrictions on the leverage of the borrowing company necessary to qualify for the risk retention exemption. This is in very

striking contrast to the final risk retention rule, which limits commercial loans qualifying for the exemption to loans made to companies with leverage ratios of below three to one, as well as imposing other caps on liabilities and debt service costs, all of which must apply on both a historical and forward-looking basis. The bill also permits securitizations to qualify for the exemption with up to 60 percent "covenant-lite" loans (loans which limit investor controls designed to ensure repayment). This is approximately double the proportion of covenant-lite loans in the market at the eve of the financial crisis.

While H.R. 4166 includes a long list of "structural protections", these supposed protections either replicate longstanding market practices (such as overcollateralization and interest coverage tests, standard in securitizations even before the financial crisis) or are inadequate to protect against excessive leverage or poor loan quality in the CLO. For example, H.R. 4166 sets an 8 percent equity standard, which permits a qualifying CLO to be leveraged at over 12 to 1. By eliminating leverage limits at the underlying portfolio companies, this leverage is inflated still further. It is also notable that the 8 percent equity standard is below the 10 percent of high-risk assets the qualifying CLO would be permitted to hold, since the 'asset quality' protections in the bill require that only 90 percent of total assets be senior secured debt (meaning that up to 10 percent could be high risk assets). Making things even worse, CLO sponsors are given an out from the already inadequate asset quality protections in the bill, since Section 7(B)(i)(VIII) of the amended risk retention statute would actually permit them to be out of compliance with a number of even the already very weak risk limits in the legislation.

HR 4166 would also reduce risk retention from 5 percent of the entire securitization to 5 percent of only the 8 percent equity tranche. This reduces the risk retention requirement from 500 basis points to just 40 basis points, or $400,000 in loss risk on a $100 million dollar securitization. This hardly qualifies as true 'risk retention', and is highly inadequate to properly align incentives between the securitization sponsor and the investor.

We believe that such dramatic weakening of risk retention rules is highly inappropriate, particularly given the fact that securitization activities were at the heart of the financial crisis. Particular segments of the securitization market may claim that their assets performed well relative to other types of securitizations during the financial crisis. But it should be remembered that with the partial exception of auto loans and equipment leases, effectively all non-government supported securitization markets essentially shut down to new issuance for well over a year during the financial crisis period. This speaks to the complex and opaque nature of securitizations, and the ways in which a loss of investor faith can rapidly cripple the market. All securitization markets also have in common that investors are significantly dependent on credit rating agencies to check and certify asset quality, and credit rating agencies remain a poorly regulated sector rife with conflicts of interest.

Weakening oversight seems particularly misguided in the case of CLOs. Fueled in part by stimulative Federal Reserve monetary policy, CLO markets have set issuance records in recent years. However, high yield markets are now under significant stress as Federal Reserve policies and commodity prices change. It now appears that during previous years there may have been excessive liquidity and poor controls on credit quality in some of these markets. A recent JP

Morgan analysis found that over half of mezzanine-level tranches of CLOs they examined were showing mark to market losses, up from less than 1 percent in September 2015.[15] We should work to ensure better underwriting quality in these markets, not weaken oversight.

We therefore urge Congress to reject this legislation. In addition, Congress should take steps to strengthen oversight of credit rating agencies. These entities are crucial intermediaries in securitization markets. But they face severe conflicts of interest in objective assessments of credit quality which have not been fully addressed by Dodd-Frank reforms. In addition, the Securities and Exchange Commission should complete the implementation of Dodd-Frank 621 on conflicts of interest in asset backed securitizations.

H.R. 4096 and The Volcker Rule

The Volcker Rule generally bans banks from investing in or sponsoring private equity or hedge funds. However, an exception is made for de minimis "seed" investments in startup funds, as well as for certain exempted funds. "Sponsorship" is defined to include naming the fund with the same name as the banking entity or an affiliate of the bank, as such a naming practice could lead to an inference that the bank somehow implicitly guaranteed the fund.

H.R. 4096 would relax the naming restriction in the Volcker Rule sponsorship definition as it applied to bank affiliates. The "shared name" prohibition would remain in place for the bank itself or for insured depository institutions.

In some cases such a relaxation of naming restrictions may be appropriate. However, we are concerned that when a non-bank affiliate of a major bank is large, well known, and extremely significant to the overall bank holding company, naming a fund after such an affiliate may still carry an inappropriate inference of sponsorship. An example of such a case would be the relationship between Merrill Lynch and Bank of America.

We are concerned that H.R. 4096 would also eliminate the naming restriction in such cases. Unless this issue is addressed, we would oppose the passage of H.R. 4096.

The Fundamental Review of the Trading Book (FRTB)

Witnesses were also asked to address the Basel Committee's recent review of the capital treatment of bank trading books. As discussed above, the arbitrage of capital rules for trading assets, including through the use of bank internal models, led to large amounts of excessive borrowing by major Wall Street dealer banks prior to the financial crisis. Banks exploited the mathematical complexity of market models, and their ability to use their own internal models, to enormously reduce the amount of their own equity capital that they held against trading assets. They also misclassified illiquid assets as liquid trading assets and ascribed market prices to such assets that were not reliable under stressed conditions. These manipulations were a major contributor to the financial crisis.

[15] The study is cited in Grant's Interest Rate Observer, "Trouble Times Leverage", pp. 9-11, January 29, 2016.

While regulators issued a number of changes to bank market risk capital requirements soon after the crisis to address the most egregious examples of these manipulations, they have since been engaged in a more far-reaching effort to reform treatment of the bank trading book. The Basel Committee recently finalized a set of recommended reforms to bank risk modeling that are designed to reduce inappropriate use of the trading book for non-liquid assets, increase disclosures to the market concerning bank valuation practices, and ensure that the full range of market and credit risks, including tail risks, are properly reflected in bank risk modeling.

AFR strongly supports these goals in principle, and strongly supports efforts to reform the regulation and improve the disclosure of market risk. However, we have not yet examined the FRTB in sufficient detail to determine our reaction to all elements of it, particularly in light of the modeling complexities involved. It is important to note that the FRTB is not binding and will not be binding on U.S. banks until U.S, regulators issue their own rule on these issues, which they have committed to do by 2019. In the past there has been significant diversion between U.S. regulatory rules and Basel recommendations.

Some bank lobbyists, joined by some in the international regulatory community, have also implied that new capital regulation reforms such as the FRTB should not on net increase overall bank capital requirements. We strongly disagree with this contention. Regulators should go where the analysis leads them in improving capital regulation of market risk. They should not be prevented from increasing capital requirements where such increases are appropriate, or be forced to inappropriately reduce capital in other areas because analysis of market risk shows that trading book capital should be increased. While bank capital has increased since the crisis, major banks are still permitted to borrow $20 for every dollar in hard equity capital, and still hold enormous amounts of complex derivatives and securitizations that contain embedded leverage that may not yet be properly reflected in risk models. We do not feel that the work of controlling excessive bank leverage is completed.

Other Regulatory Issues – High Frequency Trading

As noted above, concerns about market liquidity, in particular the growth of flash crashes, are also related to increases in the magnitude of automated high-frequency trading. There are many positive aspects to moving market intermediation moves away from major dealer banks toward more open and ideally more transparent exchange traded markets. However, such markets may also be more vulnerable to manipulation or instability created by algorithmic high frequency trading. Proper regulation of such trading was not an issue addressed in the Dodd-Frank Act.

Although regulators are examining this issue, we do not believe that there is currently sufficient regulatory oversight of these trading practices. Although a discussion of these issues is beyond the scope of this testimony, we believe further action is needed to address potential dangers created by automated trading. Rather than weakening rules passed in response to the manifest dangers revealed in the last crisis, it would be more appropriate for Congress to look ahead to address emerging issues related to high-frequency automated trading.

MBa

MORTGAGE BANKERS ASSOCIATION

MBA Statement for the Record for the Hearing on "The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitization"
February 24, 2016

The Mortgage Bankers Association[1] (MBA) appreciates the opportunity to submit this statement for the record regarding the Subcommittee on Capital Markets and GSEs hearing entitled, "The Impact of the Dodd-Frank Act and on the Basel III on the Fixed Income Market and Securitization" (Hearing). MBA commends Chairman Scott Garrett for holding this important hearing to address market impacts of the Dodd-Frank Wall Street Reform and Consumer Protection Act and Basel III. Our comments will address impediments to the commercial real estate securitization market and our recommendations for addressing these concerns.

With nearly $3 trillion in commercial real estate debt outstanding, the commercial real estate finance sector is a significant contributor to the U.S. economy. We remain concerned that the cumulative impact of numerous new and enhanced regulatory regimes will not only negatively impact the commercial real estate finance industry, but potentially have a broader chilling effect on the overall economy.

Our primary concern is that the added regulatory burden on commercial real estate lenders will potentially result in diminished capital availability and increased borrowing costs. During this rapidly evolving regulatory environment, MBA has worked closely with policy makers to inform them on important commercial real estate finance legislative and regulatory matters. While the commercial real estate finance market is impacted by a broad array of new regulations, our comments will focus on the elements of the Dodd-Frank Act that pose significant challenges to this industry.

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

MBA Strongly Supports the Preserving Access to CRE Capital Act

MBA strongly supports H.R. 4620, the Preserving Access to CRE Capital Act, because it addresses many of our concerns with the regulatory implementation of the Dodd-Frank risk retention rules. Specifically, the bill would provide for:

1. An exemption from risk retention for single property, single borrower commercial real estate loans.
2. For other commercial real estate loans, qualification parameters for risk retention exceptions that better reflect customary and prudent lending practices.
3. In addition to the pari passu structure provided for in the final risk retention rule, allowance of a senior/subordinate structure when there are two third-party risk retention purchasers.

As discussed below, we believe this important legislation would be further improved with the inclusion of language that would direct the federal regulatory agencies to appropriately categorize loans on single-family rental properties as commercial real estate loans.

The Risk Retention Final Rule Too Narrowly Defines Exempt Commercial Real Estate Loans

The risk retention rules under the Dodd-Frank Act will fundamentally impact the commercial mortgage backed securities (CMBS) market that currently holds more than $500 billion in commercial real estate loans. CMBS is an important source of liquidity for commercial real estate.

MBA remains concerned that the final risk retention rule could potentially hamper the CMBS market because it too narrowly defined the commercial real estate loans that qualify for a risk retention exemption. The Dodd-Frank Act called for an exemption for commercial real estate loans that were "low risk loans," which was subsequently defined in the final rule as "qualifying commercial real (CRE) loans." Analysis of the conduit and single asset, single borrower CMBS loan markets indicate that very few CMBS issuances would qualify for this exemption:

- *Conduit Loans* - Only 5.5 percent of current mortgages comprising conduit CMBS would qualify for zero risk retention. This is due primarily to the fact that the market standard 30-year amortization term is not allowed for qualifying CRE loans.

- *Single Borrower and Single Asset Loans* - Only 2 percent of CMBS comprised of single asset and single borrower loans would meet this exemption, which is also primarily due to the market standard 30-year amortization period prohibition. This low CRE loan qualifying rate is in stark contrast with the excellent performance history – 0.2 percent default rate for single asset and single borrower CMBS.

This brings into question whether the regulatory guidance is consistent with legislative intent when the rule so narrowly defines a qualifying CRE loan. The risk retention final rule should be modified to include a broader range of prudently underwritten commercial real estate loans that would be categorized as qualifying CRE loans. MBA supports H.R. 4620 because it addresses this concern.

The Risk Retention Final Rule Should Allow Greater Flexibility for Third-Party Purchasers

In the case of CMBS, the Dodd-Frank Act allows a third-party purchaser to assume the risk retention role by purchasing the subordinate horizontal risk retention position, often referred to as the "B piece." As part of the risk retention final rule, up to two purchasers may purchase the horizontal risk retention position provided that they split it on an equal or pari passu basis. In addition to the pari passu option, MBA strongly supports the ability of these purchasers to be able to create a senior/subordinate structure. Such an option will allow existing market participants to make purchases without having to modify investment structures. MBA supports H.R 4620 because it provides the option for two third-party risk retention purchasers to create a senior/subordinate structure.

The Risk Retention Rules Should Classify Loans Backed by Single-Family Rental Properties as CRE Loans

Single-family rental properties have long been a part of the U.S. housing system. As the share of households living in single-family rental properties has grown, so has the investor base. Loans that finance these properties are most naturally considered a part of the commercial real estate lending market, and thus are commercial real estate loans. The borrower of a single-family rental (SFR) loan is often a limited liability company or a corporation, and these loans are secured by multiple units, the individual values of which are accounted for in originating the loan. These loans are also underwritten using commercial real estate criteria, such as debt-service coverage ratio and expected rental income per unit. What brings SFR loans into the scope of the risk retention final rule is the recent emergence of certain securities that are comprised of SFR loans.

Because of the recent emergence of the SFR asset-backed securities (ABS) market, the final risk retention rule did not take into consideration SFR ABS. As such, SFR loans do not fit precisely within the technical definitions of either residential or commercial real estate loans at this time. As a result, informal guidance provided by the risk retention regulatory agencies indicated that SFR loans would fall under the standard risk retention category and thus would not be eligible for certain risk retention structures that are available for CMBS.

Accordingly, MBA strongly supports a technical clarification for the risk retention treatment of certain ABS that are secured by SFR properties. We recommend that the following language be considered as part of any effort to improve the risk retention rule:

> "No later than 90 days after the enactment of the Act, the agencies shall jointly add to the definition of a *commercial real estate loan* the following: Any loan secured by a leased, income-producing rental residential property, provided that such loan is included in a securitization solely comprised of these loans and/or other commercial real estate loans."

This clarification is intended to align the risk retention treatment of income-producing, single-family rental properties with their commercial real estate purpose. With risk retention becoming effective December 24, 2016, this clarification is essential for the efficient operation of the SFR ABS market.

We underscore that these SFR loans are underwritten using commercial real estate criteria. With the intended use of these properties to generate income for the borrower, commercial real estate loan is the only appropriate category for these SFR loans.

Conclusion

We thank the members of the Financial Services Committee for your attention to the commercial real estate market and are especially grateful to Congressman French Hill for his leadership on addressing these important issues through his legislation. MBA echoes Chairman Garrett's concern that the spate of recent ad-hoc regulatory initiatives "only serves to put a lid on our economic potential." We look forward to working with the Committee to support the passage of these important proposals.

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